Waivers of Subrogation

What Is “Subrogation?”

Subrogation and waivers of subrogation are terms often used in the context of construction contracts and insurance policies. Providing an accepted definition of subrogation may help in understanding the practical effect of these concepts in a construction contract setting. Black’s Law Dictionary (8th ed. 2004) defines “subrogation” as “[t]he principle under which an insurer that has paid a loss under an insurance policy is entitled to all the rights and remedies belonging to the insured against a third party with respect to any loss covered by the policy.” Stated simply, if an owner suffers a property damage loss and its insurer pays for that loss, “subrogation” is the legal mechanism that allows the insurer to “stand in the shoes” of the owner and seek damages from those who caused the loss. If the contractor who built the structure caused the property damage, either by defective work or otherwise, subrogation allows the insurer to sue the contractor to recover the amounts it paid to its insured.

On many projects, subrogation is often limited as construction contracts usually contain provisions requiring the parties to waive their right to claim damages against one another up to the amount of insurance coverage available for their losses. These “waiver of subrogation” provisions are intended to reduce the litigation that might otherwise arise due to the existence of an insured loss. The insurer only has rights against the contractor to the extent the owner has rights. If the owner has contractually waived subrogation as to the contractor, the owner’s insurer generally cannot use subrogation to recover its payment for a loss from the contractor.

Waiver of Subrogation Clauses

A common waiver of subrogation clause is the one contained in the American Institute of Architects (“AIA”) A201 General Conditions form. This clause provides that

The Owner and Contractor waive all rights 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 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 . . . .

Waivers of subrogation, such as the AIA language stated above, can be a veritable lifesaver for the contractor. Under these clauses, contractors, who would normally bear the risk of loss before project completion, may completely avoid that risk to the extent that builder’s risk or property insurance covers the loss. In this respect the contractor essentially obtains a double waiver: (1) a waiver from the owner as to claims that are covered by insurance and (2) a waiver from the insurer (via the owner’s waiver) as to the insurer’s right to subrogate its payment on the insured claim against the contractor. As courts have generally upheld the AIA waiver of subrogation clause in insurers’ subrogation suits against contractors, this clause represents a very real limitation of the contractor’s potential liability to the owner and its insurers. Thus, when any court refuses to enforce or otherwise fails to apply the standard waiver of subrogation language, contractors should take note as these clauses provide significant protection in the event of a catastrophic or expensive project loss.

Post Completion Losses - Subrogation Clause Restricted

The AIA waiver of subrogation clause was central to the resolution of the issues in Hartford Underwriters Ins. Co. v. Phoebus, 979 A.2d 299 (Md. Ct. App. 2009). That case involved the construction of an Arby’s Restaurant under the AIA A107 (1997) contract form. Phoebus was the electrical subcontractor the project. Construction was finished and the Arby’s opened for business in October 2003. The owner made final payment under the contract on January 30, 2004. The owner later purchased a property insurance policy for the Arby’s from Hartford, with effective coverage dates of October 1, 2004, through October 1, 2005. On May 8, 2005, a fire broke out in
the Arby’s, causing substantial damage. The owner submitted an insurance claim for the loss, which Hartford paid in full.

Hartford sued Phoebus and other project contractors on theories of negligence, breach of contract, and breach of warranties, alleging that, during construction, Phoebus provided defective electrical wiring, related components, and equipment, all of which caused the fire. Phoebus asserted in response that the “waiver of subrogation” clause in the AIA contract barred Hartford from pursuing the subrogation claims against Phoebus. Specifically, Phoebus argued that the owner had agreed in the contract to look only to its own property insurance to cover perils such as fire, and therefore Hartford had no subrogation rights to enforce. Hartford responded by asserting that the waiver of subrogation clause had no effect once the Arby’s was built and paid for.

**Temporal Scope of Subrogation Waiver**

The Maryland Court of Appeals noted that the case before it involved the “temporal scope” of the AIA waiver of subrogation – meaning, the question was whether the waiver of subrogation still applied to insurance purchased after the project was built and paid for and whether it applied to subsequent losses under that insurance. In looking at this issue, the court focused on the meaning of the phrase “other property insurance applicable to the Work,” in the AIA language and the meaning of the AIA contract’s definition of “Work.” Under the AIA form,

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

The court theorized that if this definition of “Work” includes the completed Arby’s, then the Hartford insurance policy is “other property insurance applicable to the Work” and the waiver of subrogation clause was operative when the owner obtained the Hartford insurance policy. Phoebus would be fully protected in this outcome. Conversely, if the definition of “Work” does not include the completed Arby’s, the waivers of subrogation clause had no effect when the fire loss was sustained, and Hartford could pursue Phoebus. After reviewing numerous decisions on the AIA language, the court found that the waiver of subrogation and definition of “Work” were “ambiguous” under the facts before it.

Notably, the *Phoebus* court stated that had there been a “Completed Project Insurance clause” in the parties’ contract, the court would have found the waiver of subrogation language as applying to the completed Arby’s. The typical Completed Project Insurance clause states:

“[I]f after final payment property insurance is to be provided on the completed Project through a policy or policies other than those insuring the Project during the construction period, the Owner shall waive all rights in accordance with [the waivers of subrogation clause] for damages caused by fire or other perils covered by this separate insurance. . . .”

Because the Completed Project Insurance clause was not contained in the parties’ AIA A107 contract, the court did not adopt the position advanced by Phoebus and uphold the waiver of subrogation clause as a matter of law.

**Subrogation Clause Deemed Inapplicable**
Because the court found the waiver of subrogation clause to be ambiguous in relation to the meaning of the “Work” under the AIA language, the court looked at these terms under the contract as a whole. Under the court’s reading, the “Work” did not encompass the completed Arby’s and therefore the Hartford policy was not “other property insurance.”
applicable to the Work.” This reading of the AIA language has the effect of invalidating the waiver of subrogation language argued by Phoebus. The court justified its stance by noting that public policy supports the notion that waiver of subrogation clauses in “construction contracts pertain to the period of time in which construction is taking place, and not to the (unlimited) period of time after construction and final payment, when the structure is built and being used and the parties no longer are working together to accomplish that.” Based on this ruling, Hartford could pursue Phoebus and other contractors of the Arby’s for the amount of the insurance claim paid to the owner.

Comment

The *Phoebus* case offers a clear warning to contractors regarding waivers of subrogation. From the contractor’s perspective, the “temporal scope” of the waiver should be clear and unambiguous. That is, if the parties agree that the waiver of subrogation should survive termination, completion, or final payment, then this should be clearly stated in the waiver clause, using plain and direct language. *Phoebus* also reinforces the proposition that contractors should always include the Completed Project Insurance clause when using the AIA waiver of subrogation language in their contracts. Failure to do so may render the waiver of subrogation “ambiguous” or invalid where post-completion claims are paid by the owner’s insurers. In any event, contractors must be aware of the precise nature of the waiver of subrogation clauses in their contracts – failure to take the appropriate steps in this regard could lead to liability for a catastrophic project loss, even when such loss occurs well after the project is finished.