

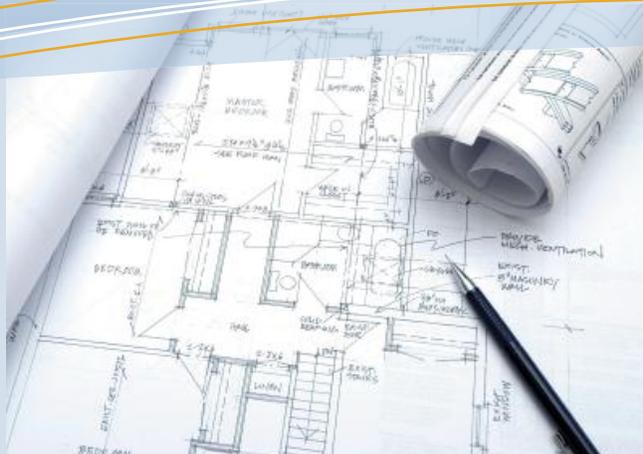
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## Risk Management Tools for the Design Professional



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### Waiver of Subrogation: A Valid Defense for Architects and Engineers?

by *W. James Johnson, Esquire and Travis L. Smuckler, Esquire*

An attorney is asked to defend an architect in a claim for defective design of a geothermal HVAC system, which allegedly caused an explosion and several million dollars of property damage to an owner's manufacturing facility. He reviews the file, making notes. The plaintiff is the owner's casualty insurer, which has paid the claim and sued the general contractor in subrogation. It's actually the general contractor who has named the architect as a third-party defendant, seeking contribution and indemnity. All sorts of interesting defenses present themselves: statute of repose (work was completed years ago), no common law indemnity claim, no negligence...but what about the contracts for the original project?

Contained within the AIA A201 General Conditions is a boiler plate "waiver of subrogation" clause. It appears to bar subrogation claims for damages covered by insurance on the property. The owner's carrier picked up the tab, so how can it sue in subrogation now? Are these waivers of subrogation provisions enforceable?

Since the project is in North Carolina, our inquiry starts with a 1987 North Carolina Court of Appeals decision, *St. Paul Fire & Marine Insurance Company v. Freeman-White Associates, Inc.*<sup>1</sup> The case involves an architect who performed design services for a Charlotte, North Carolina hospital. During construction, a wing of the hospital collapsed, causing significant property damage. The hospital's insurer paid the claim under an "all risk" policy and then sued the architect in subrogation. The agreements between the parties to the construction incorporated the AIA A201 General Conditions, including its standard waiver of subrogation clause, and the clause was applied by the trial court to dismiss the complaint against the architect under Rule 12(b)6. Unfortunately, on appeal, the court of appeals declined to



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enforce the waiver of subrogation provision and reversed the trial court's dismissal.

The rationale? The appeals court held that because the contract required the architect to provide coverage for its own errors and omissions, the contract was susceptible to two interpretations: 1) the true intent of the contracting parties was that the owner would waive all claims for damages against which the owner had insured itself; or 2) the contracting parties intended for the architect to insure against its own negligence in order to negate the waiver as to losses caused by the architect's negligence.

Not a great result for the client. However, *St. Paul Fire & Marine Insurance Company v. Freeman-White Associates, Inc.* is a 1987 decision. Surely there has been some better law made since then...

### Waiver of Subrogation in General in Construction Contracts

"Subrogation is the substitution of [one person or entity] to the position of another, an obligee, whose claim he has satisfied..."<sup>2</sup> Thus, in the insurance context, the doctrine of subrogation allows an insurer who has indemnified its insured to step into the shoes of its insured and sue any at-fault party which may have caused the damages.<sup>3</sup> The right of subrogation may arise by equitable, common law principles, or by virtue of any express assignment in the insuring agreement. The policies underlying subrogation are appealing: 1) it feels "fair" that the ultimate liability for a loss should land on the wrongdoer, not an insured's insurer; 2) in theory, subrogation should keep insurance premiums down; and 3) parties remain incentivized to avoid mistakes. In addition, fault-based claims in the midst of construction can cause delays and increased hostility during the project.<sup>4</sup> Costly litigation would ensue, the avoidance of which was one of the purposes for which the property insurance was originally obtained.<sup>5</sup>

Under an express waiver of subrogation clause in a construction contract, the parties to a project waive all rights they have against one another for damages to the extent that such damages are covered by insurance. This has the effect of shifting the risks of loss onto the insurers.<sup>6</sup> The American Institute of Architects A201 subrogation clause reads as follows:

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



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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, Architect's consultants, separate contractors described in Article 6, if any, and the subcontractors, sub-subcontractors, agents and employees of any of them, by appropriate agreements, written where legally required for validity, similar waivers each in favor of other parties enumerated herein. The policies 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 an insurable interest in the property damaged.<sup>7</sup>

By waiving their claims against each other, the contracting parties prevent their insurers from pursuing subrogation claims, since a subrogee has no greater rights than the subrogor.

In addition to such express waivers of subrogation, courts have also recognized implied waivers of subrogation in agreements requiring one party to provide insurance.<sup>8</sup> These courts reason that if a construction contract calls for a particular party to procure insurance, the parties must have intended for risks of loss to be allocated with such insurance.<sup>9</sup> If the waiver applies, parties are relieved of the obligation of purchasing redundant coverage for the same risk, which reduces economic inefficiencies.<sup>10</sup>

### **Enforceability of Waivers of Subrogation**

Most courts across the country hold, in general, that waivers of subrogation in the construction context are both valid and enforceable.<sup>11</sup> After all, courts recognize the important role waivers of subrogation play in the construction world<sup>12</sup> in avoiding "disruption and disputes among the parties to a project... [and thus eliminating] the need for lawsuits and [protecting] the contracting parties from loss by bringing all property damage under the...insurance."<sup>13</sup> Enforcing the provision validates the risk allocation decisions made through the construction agreement. Further, these courts have perceived that waivers of subrogation are not simple exculpatory provisions intended to relieve a party of liability for its own negligence.<sup>14</sup>

Is this fair to the insurers to get stuck "holding the bag" due to the waiver? Courts analyzing the issue from the standpoint of the insurer have generally recognized

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that insurers are able to protect themselves adequately from such waivers. Insurers are aware of the risks associated with the waivers, and they are able to utilize policy exclusions, increase premiums, contract around the waivers with their insured, or obtain their own insurance against the increased exposure.<sup>15</sup>

The following cases uphold the enforceability of waiver of subrogation provisions.

In *Intergovernmental Risk Mgmt. ex rel. Village of Bartlett v. O'Donnell, Wicklund, Pigozzi & Peterson Architects*,<sup>16</sup> an architect designed a new police station for a municipality. During construction a fire occurred at the station, causing substantial damages. The municipality's insurer paid the majority of the claim and then sued the architect alleging negligence in the design which caused the fire. The architect moved to dismiss based on a waiver of subrogation provision contained in the construction contracts. The Illinois trial court and the Appellate Court of Illinois agreed, holding that the insurer, as subrogee, had no greater rights than the insured and that the insurer's claims were, therefore, barred. As a result, the waiver was effective in maintaining the risk allocation intended by the parties.

In *Best Friends Pet Care, Inc. v. Design Learned, Inc.*,<sup>17</sup> a property owner contracted with a contractor for the construction of a pet care facility. The contract between the owner and contractor was a standard form AIA contract and contained a waiver of subrogation clause which stated, in relevant part, that the parties "waive[d] all rights against each other and against the Contractors, Architect, consultants, agents and employees of any of them, for damages, but only to the extent covered by property insurance..." The contractor hired the Design Learned firm to provide design consulting services for the pet care facility. While the facility was under construction, it caught fire and was destroyed. The owner's insurer compensated the owner for the loss and then filed a subrogation action against all parties to the construction, including Design Learned. The architect asserted the waiver in a motion for summary judgment and prevailed. The decision was affirmed by the court of appeals, which agreed the designer could not be held liable for damages to property to the extent such damages were covered by insurance. The waiver of subrogation provision barred the owner's claims as to the damaged property, although the waiver did not necessarily bar a claim for loss of use of the facility.

### Exceptions to Effectiveness

Unfortunately for designers, not all courts have been so kind, including the North Carolina Court of Appeals as noted in the opening paragraphs of this paper. A review of decisions indicates certain exceptions and problems with enforcement of

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the waiver of subrogation provisions, including the following:

1) **Where a loss exceeds or is not covered by applicable insurance**—Parties utilizing waivers of subrogation typically only waive subrogation “to the extent insurance covers a loss.” Thus, if there is no insurance coverage for a particular loss, the waiver is inapplicable and the damaged party is not precluded from suing anyone he or she believes to be responsible for said loss. This scenario arises where an insurance policy does not cover a particular type of loss, where an insurance policy specifically excludes certain losses from coverage, or where a particular loss exceeds insurance coverage limits.<sup>18</sup> It should be noted here that most courts hold that waivers of subrogation do not apply to a party’s right to recover any deductible paid as a result of a loss.<sup>19</sup>

In *Carlson Rests. Worldwide, Inc. v. Designline Constr. Servs.*,<sup>20</sup> a TGIF restaurant caught fire and was severely damaged. The restaurant was compensated for its entire loss except for a \$500,000 deductible it had to pay in accordance with its insurance policy. The restaurant brought suit, in part, against a subcontractor for the amount of the deductible, contending that the waiver of subrogation provision did not bar the restaurant from recovering the deductible. The trial court held the waiver of subrogation barred all claims where insurance was applicable and this included the restaurant’s claim to recover its deductible. However, the Superior Court of New Jersey reversed, holding that the deductible was recoverable. In so holding, the court noted that the contract was silent “as to uninsured losses, including deductibles,” and that the contract could reasonably be interpreted to mean the parties only waived claims where insurance actually provided coverage.

2) **Where the intent to waive claims is not clear or seems limited in some way**—Waivers of subrogation are also found unenforceable or partially unenforceable in cases where the contracting parties’ intent to allocate risk is not clear.<sup>21</sup>

For example, in *Town of Silverton v. Phoenix Heat Source Sys.*,<sup>22</sup> a town contracted with a general contractor for the installation of a new roof on its town hall. As part of the project a subcontractor was to manufacture and install a snow melting system for the roof. All parties signed a standard form AIA contract, which contained a waiver of subrogation provision providing that the parties waived claims against one another for damages to the extent such damages were covered by insurance “applicable to the work.” After the project was completed, the town hall was damaged by a fire, and the town was compensated by its insurer for damages. The insurer assigned its subrogation rights back to the town, and the town brought suit against the subcontractor on the theory that the snow melting system was



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negligently manufactured or installed. The subcontractor, citing the waiver of subrogation provision, moved and successfully dismissed the action. On appeal, the town argued that the waiver was limited to the value of “the work,” i.e., the new roof. Accordingly, the waiver did not apply to the other portions of the facility which were damaged in the fire. The Colorado Court of Appeals agreed and held that the town could recoup payments made by the insurer where such payments were for damages outside the damage to the roof.

3) **Cases involving gross negligence**—There is a split of authority as to whether the waiver will be enforced in cases involving gross negligence.<sup>23</sup> Some courts have held that a waiver of subrogation is ineffective against claims of gross negligence while other courts have held waivers of subrogation are effective against claims of gross negligence.

For example, in *Colonial Props. Realty P'Ship v. Lowder Constr. Co.*,<sup>24</sup> a property owner hired a general contractor for construction of an apartment complex in Macon, Georgia. A year after the project was completed, a fire extensively damaged the complex. The owner's insurer compensated the owner and brought a subrogation action against the general contractor, which included allegations of gross negligence. The general contractor asserted the waiver of subrogation as a defense and prevailed on summary judgment. However, the Court of Appeals of Georgia reversed in part on public policy grounds, holding that a waiver of subrogation clause, essentially an exculpatory clause, would not be enforced to bar claims for gross negligence or willful or wanton conduct.

4) **Enforcement of the waiver to damages occurring after completion of the project**—Some courts have held that waivers of subrogation do not apply once a project has been completed.<sup>25</sup> Why? Because many waiver of subrogation provisions, including the one contained in most AIA standard forms when read alone, are arguably ambiguous as to whether the contracting parties intended to waive claims for losses that arise after project completion. For example, one AIA standard form waiver of subrogation provision states, in pertinent part, that the parties agree to waive all claims “for damages...to the extent [they are] covered by...insurance applicable to the Work.” What does “work” mean? Does it mean the parties to the contract waive all claims against each other for all losses stemming from the “work” for all time, or does it mean the parties to the contract simply waive their claims against each other while the “work” is in process? Courts have been split on this issue. Many courts have found such a waiver only applies for losses which arise while work is in process because it is not clear that the contracting parties intended to waive later arising losses.<sup>26</sup> Other courts have found that the

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same provision does in fact apply to losses arising after a project's completion.<sup>27</sup>

Where courts believe the parties to a contract intended for a waiver to apply to post-project losses, they will usually enforce the waiver for such losses.<sup>28</sup> Substantial evidence relied upon by many courts is whether the project contract contains a *subrogation continuation provision* along with a waiver of subrogation provision. Subrogation continuation provisions are contained in most current standard form AIA contracts. These provisions typically set forth, in addition to the standard waiver of subrogation provision, that a project's owner waives all claims he or she has for losses incurred on a completed project to the extent another insurance policy has been procured by the project owner on the completed project. Most courts have viewed these provisions as a strong indication that the parties to the contract intended to waive claims for losses sustained even after project completion. Where the clause expressly indicates it is intended to apply to post-construction losses, it will most likely be held valid for post-construction losses in most jurisdictions.<sup>29</sup> Where the clause contains language limiting the waiver to losses which occur during construction, the waiver may be disregarded where the losses are sustained post construction.

### Conclusion

A waiver of subrogation can be a useful tool in limiting the designer's exposure. However, careful counsel drafting construction agreements will want to research the law applicable to the provision in order to maximize the enforceability of the provision. Depending on the jurisdiction, the designer, with the assistance of counsel, may wish to consider adding language 1) that the parties intend that the provision shall apply to bar claims covered by property insurance, notwithstanding any requirement that the designer provide errors and omissions insurance; and 2) that the parties intend the waiver to apply to post-construction losses covered by insurance as well as those occurring during construction.

### Post Script

What about the North Carolina geothermal explosion cited in the opening of this paper? Was new law made? Did the designer prevail? Unfortunately, a small nuisance value settlement kept a challenge to North Carolina's treatment of the waiver of subrogation at bay. However, we encourage counsel to consider waiver of subrogation provisions in project agreements and as defenses in liability matters where appropriate.



### ENDNOTES

- <sup>1</sup> *St. Paul Fire & Marine Ins. Co. v. Freeman-White Associates, Inc.*, 86 N.C. App. 431 (N.C. Ct. App. 1987).
- <sup>2</sup> *Hill v. Cross Country Settlements, LLC*, 402 Md. 281, 312, 936 A.2d 343, 362 (2007).
- <sup>3</sup> *John L. Mattingly Constr. Co. v. Hartford Underwriters Ins. Co.*, 415 Md. 313, 319 (Md. 2010), citing *Robert E. Keeton and Alan I. Widiss, Insurance Law: A Guide to Fundamental Principles, Legal Doctrines, and Commercial Practices* § 3.10, at 219 (student ed. 1988).
- <sup>4</sup> See, e.g., *John L. Mattingly Constr. Co. v. Hartford Underwriters Ins. Co.*, 415 Md. 313, 319 (Md. 2010) and *Hartford Underwriters Ins. Co. v. Phoebus*, 187 Md. App. 668 (Md. Ct. Spec. App. 2009).
- <sup>5</sup> See, e.g., *Hartford Underwriters Ins. Co. v. Phoebus*, 187 Md. App. 668 (Md. Ct. Spec. App. 2009) and *Acadia Ins. Co. v. Buck Constr. Co.*, 2000 ME 154 (Me. 2000).
- <sup>6</sup> *South Tippecanoe School Bldg. Corp. v. Shambaugh & Son, Inc.*, 395 N.E.2d 320 (Ind. Ct. App. 1979).
- <sup>7</sup> American Institute of Architects (AIA) Document A201.
- <sup>8</sup> See, e.g., *Berger v. Teton Shadows, Inc.*, 820 P.2d 176 (Wyo. 1991) and *Tuxedo Plumbing & Heating Co. v. Lie-Nielsen*, 245 Ga. 27 (Ga. 1980).
- <sup>9</sup> See, e.g., *Berger v. Teton Shadows, Inc.*, 820 P.2d 176 (Wyo. 1991) and *Tuxedo Plumbing & Heating Co. v. Lie-Nielsen*, 245 Ga. 27 (Ga. 1980).
- <sup>10</sup> *TX. C.C., Inc. v. Wilson/Barnes Gen. Contractors, Inc.*, 233 S.W.3d 562 (Tex. App. Dallas 2007)
- <sup>11</sup> 73 Am Jur 2d Subrogation § 77 and 43 Am Jur 2d Insurance § 1784.
- <sup>12</sup> See e.g. *Travelers Indem. Co. v. Crown Corr, Inc.*, 2011 U.S. Dist. LEXIS 148529 (D. Ariz. Dec. 27, 2011).
- <sup>13</sup> *United States Fidelity & Guar. Co. v. Farrar's Plumbing & Heating Co.*, 158 Ariz. 354, 355 (Ariz. Ct. App. 1988) citing *Tokio Marine & Fire Ins. Co. Employers Ins. of Wausau*, 786 F.2d 101, 104 (2d Cir.1986).
- <sup>14</sup> See e.g. *Best Friends Pet Care, Inc. v. Design Learned, Inc.*, 77 Conn. App. 167 (Conn. App. Ct. 2003) and *Jalapenos, LLC v. GRC Gen. Contr., Inc.*, 2007 PA Super 391 (Pa. Super. Ct. 2007).
- <sup>15</sup> *MiddleOak Ins. Co. v. Tri-State Sprinkler Corp.*, 77 Mass. App. Ct. 336 (Mass. App. Ct. 2010).
- <sup>16</sup> *Intergovernmental Risk Management v. O'Donnell, Wicklund, Pigozzi & Peterson Architects, Inc.*, 295 Ill. App. 3d 784, 790, 692 N.E.2d 739, 742, 229 Ill. Dec. 750 (1998).
- <sup>17</sup> *Best Friends Pet Care, Inc. v. Design Learned, Inc.*, 77 Conn. App. 167 (Conn. App. Ct. 2003)
- <sup>18</sup> See, e.g., *Gap, Inc. v. Red Apple Companies, Inc.*, 282 A.D.2d 119, 725 N.Y.S.2d 312 (1st Dep't 2001) and *Hancock Fabrics, Inc. v. Alterman Real Estate I, Inc.*, 302 Ga. App. 568 (Ga. Ct. App. 2010).
- <sup>19</sup> See, e.g., *Gap, Inc. v. Red Apple Companies, Inc.*, 282 A.D.2d 119, 725 N.Y.S.2d 312 (1st Dep't 2001).
- <sup>20</sup> *Carlson Rests. Worldwide, Inc. v. Designline Constr. Servs.*, 2009 N.J. Super. Unpub. LEXIS 2365 (App.Div. Sept. 4, 2009).
- <sup>21</sup> See, e.g., *Hartford Underwriters Ins. Co. v. Phoebus*, 187 Md. App. 668 (Md. Ct. Spec. App. 2009); *Town of Silverton v. Phoenix Heat Source Sys.*, 948 P.2d 9 (Colo. Ct. App. 1997); *Copper Mt., Inc. v. Indus. Sys.*, 208 P.3d 692 (Colo. 2009).
- <sup>22</sup> *Town of Silverton v. Phoenix Heat Source Sys.*, 948 P.2d 9 (Colo. Ct. App. 1997).
- <sup>23</sup> *Lexington Ins. Co. v. Entrex Commun. Servs.*, 275 Neb. 702 (Neb. 2008).
- <sup>24</sup> *Colonial Props. Realty P'Ship v. Lowder Constr. Co.*, 256 Ga. App. 106 (Ga. Ct. App. 2002).
- <sup>25</sup> *Automobile Ins. Co. v. United H.R.B. Gen. Contractors*, 876 S.W.2d 791 (Mo. Ct. App. 1994); *Haren & Laughlin Constr. Co. v. Jayhawk Fire Sprinkler Co.*, 330 S.W.3d 596 (Mo. Ct. App. 2011); *Turner Construction Co. v. John B. Kelly Co.*, 442 F.Supp. 551 (E.D.Pa. 1976); *McBroome-Bennett Plumbing, Inc. v. Villa France, Inc.*, 515 S.W.2d 32 (Tex.Cir.App. 1974).
- <sup>26</sup> *Automobile Ins. Co. v. United H.R.B. Gen. Contractors*, 876 S.W.2d 791 (Mo. Ct. App. 1994); *Haren & Laughlin Constr. Co. v. Jayhawk Fire Sprinkler Co.*, 330 S.W.3d 596 (Mo. Ct. App. 2011); *Turner Construction Co. v. John B. Kelly Co.*, 442 F.Supp. 551 (E.D.Pa. 1976); *McBroome-Bennett Plumbing, Inc. v. Villa France, Inc.*, 515 S.W.2d 32 (Tex.Cir.App. 1974).
- <sup>27</sup> See, *Acuity v. Interstate Constr.*, 2008 Ohio 1022 (Ohio Ct. App., Portage County Mar. 7, 2008) versus *Automobile Ins. Co. v. United H.R.B. Gen. Contractors*, 876 S.W.2d 791 (Mo. Ct. App. 1994).
- <sup>28</sup> See, e.g., *MiddleOak Ins. Co. v. Tri-State Sprinkler Corp.*, 77 Mass. App. Ct. 336 (Mass. App. Ct. 2010).
- <sup>29</sup> *Id.*



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