

Waiver of Subrogation Provisions in Construction Contracts - Part One

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Larry Bowman and I recently wrote a 44-page white paper on “The Ins and Outs of Waivers of Subrogation.” Larry presented our paper at the 34th Annual Texas Construction Law Conference sponsored by The Construction Law Foundation of Texas and The Construction Law Section of the State Bar of Texas, which was held virtually/online in early March and had over 750 attendees. When the conference planning committee approached us about presenting on the topic, they asked us this hypothetical question – Should your construction contract include a waiver of subrogation?

To answer this question, we explored the purpose and benefits of subrogation generally and discussed considerations in determining whether a waiver of subrogation may be advantageous or harmful to certain contracting parties. We also examined typical subrogation provisions and waivers found in insurance policies and construction contracts.

Contracting parties must first understand the potential benefits of subrogation generally. While a subrogation recovery obviously benefits the insurer by allowing them to recoup a portion of the money paid out to cover an insured’s loss, subrogation can also have economic benefits that flow to insureds. For example, when there is a recovery on a subrogation claim, the insured may obtain a portion of the proceeds or a full reimbursement of its deductible without having to bear the cost and risk of litigation, which are borne by the insurer. Moreover, if an insurer has a successful overall subrogation program (meaning that the insurer’s aggregate subrogation recoveries are greater than its aggregate costs in pursuing subrogation claims), this will result in additional income for the insurer, and the insurer may be willing and able to charge lower premiums to its insureds. Finally, when an insurer decides to underwrite a risk, they will typically consider the insured’s prior loss history, including information about amounts paid and amounts recovered through salvage and subrogation. In this evaluation, a subrogation recovery may help offset the increased premium that could otherwise apply due to a prior loss.

Beyond these benefits to insurers and their insureds, there is also a societal benefit provided by subrogation in that it helps deter undesirable loss-causing conduct. In other words, by allowing the insurer to pursue claims against the ultimate wrongdoer who caused the loss, subrogation can create a safer and more efficient market because negligent and other bad actors are held accountable and incentivized to provide better services or products, thereby reducing the incidence of future losses.

Despite the general benefits of subrogation discussed above, waivers of subrogation are commonly found in construction contracts, and many construction industry groups, like the American Institute of Architects (AIA), the Consensus Docs Coalition, and the Design-Build Institute of America, have developed form waiver provisions. From a legal standpoint, because an insurer’s subrogation rights are derivative of its insured’s rights, if the insured waives subrogation in a contract with a third party, the insurance company cannot step into its insured’s shoes to sue that third party and recover damages caused by that third party. Waiver of subrogation provisions serve to transfer the risk of insured losses to a single insurer

(in the construction context, usually that of the owner) and can effectively minimize or preclude claims and lawsuits between the project participants for insured losses.

As recognized by many courts across the country, the intent of subrogation waivers in construction contracts is to avoid disruption during construction, provide certainty, and eliminate litigation by having the contracting parties look only to the owner's insurance for protection in the event of an insured loss. Courts have also stated that it would be economically inefficient for multiple parties to insure against the same risk. Despite this economic inefficiency argument, it is common for construction contracts to not only require the owner to purchase and maintain builder's risk insurance or other property insurance, but also to require the general contractor and its subcontractors to purchase and maintain commercial general liability insurance with specified minimum limits covering both property damage and bodily injury claims.

Let's turn back now to our hypothetical question – should your construction contract include a waiver of subrogation? Contracting parties trying to answer this question for a given project should be aware that broad form waiver provisions primarily benefit contractors and design professionals and the subcontractors and consultants they hire. Owners, on the other hand, may be better served if the scope of a waiver provision is more limited. For example, while subrogation waivers may help to avoid disruption during construction, there are many broad form waiver provisions that extend to losses that occur after construction is complete. Owners should pay close attention to the scope of any waiver of subrogation proposed to be included in a construction contract – in terms of not only the time period and the parties to be covered by the waiver but also whether certain types of losses may be excluded from the waiver. Owners should also be aware of the differing interpretations by courts of form waiver of subrogation provisions when negotiating their contracts so that they can effectively manage potential risks.

In Part Two, I will provide a more comprehensive list of issues that parties should consider when drafting or evaluating the scope of a waiver of subrogation provision in a construction contract.

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