

WAIVERS OF SUBROGATION – THE LAW OF UNINTENDED CONSEQUENCES

By Gary Dankert and Rebecca Seamands

Waiver of subrogation provisions are frequently used in construction contracts to urge the parties to identify potential risks before they happen and to obtain property insurance to address those risks to minimize disputes both during and after construction. The general concept of a waiver of subrogation is that the parties agree that project risks are to be borne solely by property insurance (the responsibility for procuring such insurance being assigned to a party in the contract), even if the loss may be caused by the negligence of one of the parties to the agreement. Although the goal of "placing the risk of loss on insurance" is generally encouraged and endorsed by owners and construction professionals alike, two recent Indiana Court of Appeals cases illustrate how the potential consequences of such provisions are not always clear.

The first of these decisions is *Allen County Public Library v. Shambaugh & Son, L.P.*, 997 N.E.2d 48 (Ind. Ct. App. 2013), in which the Library undertook a project to renovate its branch building in Fort Wayne, Indiana. The Library entered contracts with various contractors including Shambaugh & Son, who was contracted to perform the mechanical, electrical and fire protection work, and Hamilton Hunter, who was contracted to perform the concrete work. The contracts were based on standard form agreements issued by the American Institute of Architects ("AIA"), which included insurance provisions in paragraph 11.3 that among other things: (1) required the Library (Owner) to purchase and maintain property insurance in the amount of the Contract Sum "for the entire Work at the site on a replacement cost basis"; (2) required that such property insurance be on an "all risk" policy form and that protected the interests of the Library and the various contractors and sub-contractors in the Work; (3) required that if the Library intended not to purchase such property insurance with the described coverages, that it inform the contractor in writing prior to commencement of the Work so that the contractor could purchase such insurance coverage (the costs of which would be a change order paid by the Library). The contracts further included the following standard waiver of subrogation provision:

"The Owner and Contractor waive all rights against each other and against the Construction Manager, Architect, Owner's other Contractors and own forces and the subcontractors, sub-subcontractors, consultants, agents and employees of any of them, for damages caused by fire or other perils to the extent covered by property insurance obtained pursuant to this Paragraph 11.3 or other property insurance applicable to the Work, except such rights as the Owner and Contractor may have to the proceeds of such insurance held by the Owner as fiduciary...."

"Work" was defined in the contracts as, "the construction and services required by the Contract Documents, whether completed or partially completed, and includes all other labor, materials, equipment and services provided by the Contractor to fulfill

the Contractor's obligations. The Work may constitute the whole or part of the Project."

The Library obtained a builders risk insurance policy that covered the building, foundations, excavations, underground pipes and other elements of the project that were to become part of the permanent structure at the job site. Although the policy contained an exclusion for water and the land on which the property was located, a coverage extension called "Pollution Clean Up and Removal" covered expenses to extract pollutants from land or water at the job site resulting in loss to Covered Property. The Pollution Clean Up and Removal coverage had a separate policy limit of \$5,000.

During construction, a hole was discovered in copper piping leading to underground diesel fuel storage tanks, resulting in approximately 3000 gallons of fuel to leak into the ground under the Library. The Library believed the hole in the piping occurred when a Hamilton Hunter employee drove a steel stake in the ground while constructing concrete forms. The Library filed a claim against the builders risk insurance policy and the insurer paid its \$5,000 limit for pollution cleanup. The Library then filed a lawsuit against various contractors, seeking to recover the more than \$490,000 in the additional clean-up expenses that had been incurred thus far, with the costs expected to increase into the future as the clean-up efforts continued.

The trial court ruled in favor of the contractors as a matter of law, based on the waiver of subrogation provision and the Library appealed. The Indiana Court of Appeals reversed, holding that the waiver of subrogation provision did not prevent the Library from seeking recovery for the pollution cleanup costs in excess of those covered by the policy. The Court held that the Library's waiver of rights to subrogation applied only to claims falling within the scope of "the Work", and because the damage at issue was to property that was outside the scope of "the Work", the waiver of subrogation language did not apply.

A different result was reached just a few months later in the case of *Board of Commissioners of County of Jefferson v. Teton Corp.*, 3 N.E.3d 556 (Ind. Ct. App. 2014). The project in the TETON Corp. case was also a renovation, this time to the county courthouse. The Owner in TETON had similar contractual obligations to procure and maintain property insurance as the Owner in Allen County Public Library. However, unlike the Library, the Owner in TETON did not obtain separate property (or builders risk) insurance for the project, but instead relied on its existing property and casualty insurance. Additionally, Jefferson County did not inform the contractors that it did not intend to obtain separate insurance for the project.

A fire occurred during construction, resulting in more than \$6 million in damage to the courthouse. Jefferson County sued the general contractor and subcontractors, alleging the fire was caused by their negligence, breach of implied warranties and/or

breach of contract. The defendants moved for summary judgment, arguing that the Owner had agreed to provide insurance for the project and had waived its subrogation rights against the defendants. Jefferson County disagreed, arguing that not all of the damage was covered by the property policy, and that in fact, the case involved damage to property that was not part of the Work of the project (so-called "non-Work" property). The trial court ruled in favor of the defendant-contractors, and the Indiana Court of Appeals affirmed the decision on appeal.

The Court of Appeals held that the waiver of subrogation clause extended to all losses covered by the Owner's property insurance policy, irrespective of whether the damage at issue was within the definition of "Work" in the construction contracts. The Court in TETON acknowledged its disagreement with the decision from a different panel of judges in the Allen County Public Library case, and said that if the result in TETON were applied to the Allen County Public Library case, then the Library's recovery in the latter case would have been limited to the \$5,000 limits from the insurance policy.

Both decisions noted differing perspectives on this area of the law by courts across the country. The cases recognized that the "majority view" among jurisdictions in other states is that when considering the reach of waiver of subrogation clauses, courts have rejected the "Work" v. "non-Work" distinction applied in the Allen County Public Library case. Instead, the majority of courts addressing the issue have focused on the intent to waive subrogation rights reflected in the standard AIA contract language, and the public policy goals of encouraging and enforcing the parties' choices as to allocation of risk.

In reaffirming its decision when the Library requested a rehearing, the Court in the Allen County Public Library case distinguished its holding from those of other cases by noting that the owners in those other cases (like the Owner in TETON) did not purchase insurance for the project that was contemplated by the contracts, and they did not inform the contractors of that decision. Instead they simply relied on property insurance that already was in place. Conversely, the Library in Allen County Public Library had purchased builders risk insurance as required by the contract.

These recent Indiana Court of Appeals cases leave some uncertainty as to whether contractors have exposure for damage to "non-Work" property notwithstanding contractual language that the owner has agreed to waive subrogation rights. The outcome of a particular case may depend on whether the owner purchases project-specific (builders risk) insurance as required by the contract. As a practical matter, owners should take seriously any obligation to purchase insurance, particularly if it is required to also protect the interests of the contractors. The owner also should be cognizant of any obligation to notify the contractors of its intent to not purchase such insurance. For their part, contractors should review any project-



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specific coverage obtained by the owner to determine whether it is appropriate to supplement the coverage based on the work it will be performing on the Project. Failure to follow the insurance provisions, like other requirements of the contract, can have unintended consequences for all parties.

This article is intended for general information purposes only and does not and is not intended to constitute legal advice. The reader should consult with legal counsel to determine how laws or decisions discussed herein apply to the reader's specific circumstances. 🛑

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