SUBROGATION WAIVERS:

HOW IS THEIR SCOPE DEFINED?

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I. THE INSURER'S RIGHT TO SUBROGATION

In Texas, two types of subrogation exist, legal subrogation (also known as equitable subrogation) and conventional subrogation (also known as contractual subrogation). An insurance company's right to subrogation arises as a result of payment of a claim by the insurer under a policy; this is legal subrogation. Conventional subrogation arises due to a contract entered into by the parties. Another impact that contracting can have on subrogation rights is to narrow and/or eliminate them through contractual clauses such as subrogation waivers. An insured can enter into a contract that affects the insurer's subrogation rights. Subrogation waivers are allowed and enforced under Texas law. "The general rule is that a release between the insured and the offending party prior to the loss destroys the insurance company's rights by way of subrogation." *Trinity Universal Insurance Company v. Bill Cox Construction, Inc.*, 75 S.W.3d 6, 10 (Tex.App.—San Antonio 2001, no pet.).

An insurer's right to pursue reimbursement for payment on a claim is dependent upon the claims the insured has a right to pursue; the insurer's claims are derivative of the insured's claims. While paying the claim under the policy gives the insurer the right to pursue all claims available to the insured, the insurer must first establish the insured's entitlement to recovery on the claims. *Texas Assoc. of County Government Risk Management Pool v. Matagorda County*, 52 S.W.3d 128, 131 (Tex. 2000); *Westchester Fire Ins. Co. v. Admiral Ins. Co.*, 152 S.W.3d 172, 178-179 (Tex.App.–Ft. Worth 2004, pet. filed). An insurer can only recover what the insured could have recovered and cannot profit at the expense of the insured. For example, an insurer cannot recover the attorney fees it must expend to pursue the subrogation claim unless the insured would have been entitled to attorney fees had it pursued the claim. *Rushing v. International Aviation Underwriters, Inc.*, 604 S.W.2d 239, 245 (Tex.App.—Dallas 1980, writ *ref'd* n.r.e.). If the insured's claims were waived, the insurer cannot bring a separate action to recover on the amounts it paid out. When an insured's cause of action ends, the insurance company's subrogation claim also ends. Further, "the defendant may ordinarily assert any defense against the subgoree as they have against the subrogor." *Guillot v. Hix*, 838 S.W.2d 230, 232 (Tex. 1992).

In the construction industry, insurers often face waivers of subrogation claims in contracts the insured entered into as part of the construction project. A subrogation waiver can destroy any right an insurer has to bring a subrogation claim. A subrogation waiver is intended to avoid litigation over damage claims and to protect the parties to a contract by requiring one of the parties to provide insurance for all the parties. *Trinity Universal Insurance Company*, 75 S.W.3d at 13. The waivers eliminate the need for lawsuits as the contracting parties are protected against loss by insurance. *Walker Engineering, Inc. v. Bracebridge Corp.*, 102 S.W.3d 837, 841 (Tex.App.—Dallas 2003, pet. denied).

II. HOW FAR WILL A SUBROGATION WAIVER EXTEND? AS FAR AS A LIABILITY POLICY?

Subrogation waivers can appear straight forward on their face as to the type of damage and the type of coverage or policy to which they apply. Many subrogation waivers apply directly to property insurance and sometimes equipment insurance. Despite language defining the type of policy that the waiver applies to, sometimes a court will interpret a waiver provision more broadly. In Texas, the type of policy that the claim is paid under will not be the focus of the analysis, rather the court will examine the source of the proceeds. Thus, a subrogation waiver can reach farther than many people would expect, even the contracting parties.

A. Texas recognizes a distinction between property insurance and a liability policy.

If one examines how Texas has examined property insurance policies and liability policies in other cases, a subrogation waiver that is meant to apply only to property insurance should not be extended to capture liability insurance; they are two distinct types of

insurance. Texas recognizes that a CGL policy constitutes a liability policy, not a property insurance policy. *See Bituminous Casualty Corp v. Maxey*, 110 S.W.3d 203, 207 (Tex.App.—Houston [1st Dist.] 2003, pet. denied) ("The CGL form is a standard insurance industry form widely used across the nation to provide general liability insurance to businesses."). Property insurance is first-party insurance. As both state and federal courts have noted, "The classic example of first-party insurance is property insurance. The insurance proceeds are paid by the first-party insurer directly to the insured to redress the insured's actual, direct loss." *Lennar Corp. v. Great Am. Ins. Co.*, 200 S.W.3d 651, 702-03 (Tex. App.—Houston [14th Dist.] 2006, pet. filed) (citations omitted) (citing *Hartman v. St. Paul Fire and Marine Ins. Co.*, 55 F.Supp.2d 600, 603 (N.D. Tex. 1998)). In contrast, the right to coverage under third-party liability insurance (*i.e.*, a CGL policy) "is established through traditional tort concepts such as fault, proximate cause and duty." *Warrilow v. Norrell*, 1990 Tex. App. LEXIS 863 at *4 (Tex. App.--Corpus Christi 1990, writ denied) (op. on reh'g) (not designated for publication). "The focus is on the insured's legal obligation to pay for an injury or damage arising out of a certain occurrence, and coverage should extend to an insured risk, negligence, which constitutes a proximate cause of the injury." *Id.* Therefore, liability and corresponding coverage under a third-party insurance policy must be carefully distinguished from the coverage analysis applied in a first-party property insurance policy. "Property insurance, unlike liability insurance, is unconcerned with establishing negligence or otherwise assessing tort liability. . . . Coverage in a property policy is commonly provided by reference to causation, such as 'loss caused by…' certain enumerated forces." *Id.* at *3

In addition, Texas law observes important distinctions between liability insurance and property insurance. A liability policy does not convert to a property insurance policy by covering property damage. Courts recognize a difference between property loss coverage under a first-party insurance policy, typically an all-risk policy, and tort liability coverage under a third-party insurance policy. "This distinction is critical." *Id.* at *2-3. "The coverage analysis in the property insurance context examines the relationship between perils, those that are covered under the policy and those that are excluded, focusing on the exclusions that limit loss coverage." *Id.* at *3 (citing *Garvey v. State Farm Fire and Cas. Co.*, 770 P.2d 704, 710 (Cal. 1989))

B. The Scope of the Subrogation Waiver

To determine whether a subrogation waiver applies, the scope of each waiver must be examined on a case-by-case basis. The damage or injury that occurred and the policy that paid the claim must be examined. The waiver's scope can be defined by the "work", i.e. whether the item damaged is part of the defined "work", or the source of the insurance proceeds, whether the claim was paid by a policy applicable to the work. Jurisdictions follow both of these approaches.

1. *The "Work"*

Defining the applicability of the subrogation waiver by the "work" requires looking at the property that was damaged and determining whether that property falls within the definition of "work" contained in the construction contract or whether the damage occurred to non-work property. The term "work" generally means the construction and services required under the contract documents and will be applied to both work in progress or completed work. The "work" also includes all other labor, materials, equipment and/or services required to complete the contractual obligations.

Under this approach, to the extent that a claim is paid for damage to property falling outside of the "work", an insurer can seek reimbursement despite a subrogation waiver. For example in *Travelers Ins. Cos. V. Dickey*, 799 P.2d 625 (Okla. 1990), non-work property suffered damage. In this case, a roofer replaced roofs on several office buildings. Before the work was completed, rain penetrated one of the roofs resulting in damage to the building's interior. The owner's insurer Travelers paid for damage and then filed suit claiming that the roofer was negligent. The construction contract provided that the owner and contractor waived all rights against each other for damages caused by fire or other peril to the extent covered by

insurance. However, the contract only required the owner to obtain coverage for the completed value of the roofing work. The Oklahoma Supreme Court addressed whether the subrogation waiver shielded the contractor from Travelers' subrogation claim. The Court focused on the fact that the owner did not bear the burden for shielding the contractor from damage to the interior of the building; rather, the contract only protected the roofer for damage connected with the work performed. As a result, Travelers could pursue the subrogation claim for the damaged interior of the building. *Id.*

If a jurisdiction analyzes the scope of the subrogation waiver in terms of whether the "work" was damaged, the type of policy at issue will not matter. The court will only look at whether work, as defined under the contract, was damaged. If the "work" was damaged, the subrogation waiver will apply. If not, then the subrogation waiver will not bar a subrogation claim. Thus, paying a claim for damage to "work" under a liability policy would result in a subrogation claim being barred as the waiver would apply.

2. *The Source of the Insurance Proceeds*

The other approach to define the scope of the subrogation waiver involves examining the source of the insurance proceeds paying for the loss. The subrogation waiver applies to the proceeds of insurance provided for in the contract between an owner and contractor. *Trinity*, 75 S.W.3d at 11. For example, a subrogation waiver may apply to damage to work covered by property insurance. Texas, along with the majority of jurisdictions, follows this second approach in examining the source of the insurance proceeds, i.e. "whether the loss was paid by a policy 'applicable to the work.'" *Id.* at 12. *See also Walker Engineering, Inc. v. Bracebridge Corp.*, 102 S.W.3d 837, 841-844 (Tex.App.—Dallas 2003, pet. denied). Courts following this approach criticize jurisdictions that make the work/non-work distinction because narrowing the analysis to only the "work" ignores the contractual language defining the scope of the claims that fall within the subrogation waiver. *Trinity*, 75 S.W.3d at 11-12. By examining the insurance proceeds that were applied to the loss, courts following this second approach interpret the scope of the waiver "as limited to the proceeds of the insurance provided under the contract, and ask whether the owner's policy was broad enough to cover both Work and non-Work property and whether the policy paid for damages." *Id.* at 12.

The source of the insurance proceeds defined what claims were waived in *Trinity Universal Insurance Company v. Bill Cox Construction, Inc.*, 75 S.W.3d 6 (Tex.App.—San Antonio 2001, no pet.). In that case, BCCI was the general contractor restoring and renovating Dog Team's building. Trinity had issued an all risk/builder's risk policy to Dog Team for the renovations. In addition, Dog Team also carried a general liability policy. A fire arose in Dog Team's building as a result of welding work performed by a subcontractor, de Leon. Trinity paid Dog Team its policy limits of $300,000 and filed a subrogation action against BCCI and de Leon. *Id.* at 8. The AIA agreement between Dog Team and BCCI contained a subrogation waiver in which Dog Team and BCCI waived all rights against each other and any subcontractors "for damages caused by fire or other perils to the extent covered by insurance obtained pursuant to this Article 17 or other property insurance applicable to the work. . . ." *Id.* at 9.

The San Antonio Court of Appeals held that the waived claims were defined by the source of the insurance proceeds. *Id.* at 13-14. In this case, the Trinity policy was obtained before the contract between Dog Team and BCCI was entered into; thus, the policy was not obtained pursuant to Article 17. However, Dog Team relied on the policy for insurance coverage the building. *Id.* at 14. "Any other property insurance applicable to the work" was interpreted as referring to "insurance applicable to the location of the work or the building containing the work. . . ." *Id.* at 15. Trinity's policy covered the damages from the fire; thus "the policy constitutes 'other property insurance applicable to the Work.'" *Id.* As Dog Team's claims against BCCI were barred to the extent the damages were covered by property insurance, Trinity had no right of subrogation. *Id.*

The analysis applied in *Trinity* also controlled in *Walker Engineering, Inc. v. Bracebridge Corp.*, 102 S.W.3d 837 (Tex.App.—Dallas 2003, pet. denied). In that case, the waiver between the building owner, MBNA, and contractor applied to "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. . . ." *Id.* at 839-840. Electrical work on the building at issue created a hole in a nearby water line and resulted in a significant portion of the first floor being flooded. MBNA's Vigilant policy provided over $800 million in building and property coverage, and the parties agreed the policy covered the water damage. Additional builder's risk insurance under the same policy applied to new construction and improvements at the building. Walker argued that the subrogation waiver barred any claims by MBNA for the damage resulting from the flooding. MBNA asserted the waiver was not applicable because the flooding was not covered by insurance obtained pursuant to Paragraph 11.3 or other insurance applicable to the work. *Id.* at 838-840.

The Dallas Court of Appeals examined the contract and the waiver. The contract placed the burden for obtaining property insurance on MBNA, and the property insurance obtained was to protect all the parties from property loss. The builder's risk coverage did not alter the contract. *Id.* at 840. The subrogation waiver was found to extend to damages covered by the entire Vigilant policy, including the builder's risk coverage. The addition of the builder's risk coverage to the policy did not change MBNA's contractual duties. MBNA's insurance was "applicable to the work" under the waiver of subrogation clause. As a result, MBNA waived its right to sue Walker under the terms of the waiver of subrogation clause. *Id.* at 844.

As shown by the *Trinity* and *Walker* cases, the specific type of policy that applies to the work is not the focus of the analysis. Rather, the analysis focuses on whether the insurance applies to the work. So for example, a liability policy paying for resulting property damage may be interpreted as insurance applicable to the work, making a subrogation waiver applicable. The arguments can be made as to the waiver only applying to "property insurance", if this limitation is contained in the waiver at issue, along with the distinctions that Texas law makes between property and liability insurance. Another factor will be whether a contractor, for example, is responsible for providing insurance under the contract. If the liability insurance constitutes insurance that the contractor relied upon to satisfy its duties under the contract or if the liability coverage is merely part of a larger policy the contractor relied upon, then the waiver would likely apply.

III. CONCLUSION

Do not assume that an insurer can simply look at the language of a subrogation waiver in a contract and define its applicability. As shown, an insurer must know how the jurisdiction the dispute is located in defines the applicability of a subrogation waiver, i.e. by the work/non-work distinction or by the source of the insurance proceeds. In either case, do not rely upon the type of policy at issue, i.e. property insurance, builders risk, liability insurance, and so on, to define the scope of the waiver. As shown the type policy at issue may not have any bearing on the scope of the subrogation waiver.