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SOMETHING FOR NOTHING

By Jon Straw

Contrary to popular belief, it is possible to get something for nothing. At least, it may appear as such in two recent cases from Pennsylvania and Missouri. Unraveling the short stories of these two cases will show that, whether defending or pursuing claims, all parties should consider if a subrogation waiver applies and if it can be asserted as a defense or if it could be a potential hurdle to overcome.

In these cases, an owner and a contractor benefited from a subrogation waiver that shifted the risk of loss to the insurer. Neither the owner or contractor were the insureds nor did their respective contracts include subrogation waivers. Nevertheless, the courts found the owner and contractor were third-party beneficiaries to subrogation waivers in related contracts for the same projects. Before the cases are briefly unraveled, a bit of foundation is helpful.

Subrogation, Waiver and Third-Party Beneficiary in a Nutshell

Basically, subrogation occurs when one party that is not a stranger to the project pays the debt of another and steps into the other's shoes. Stepping into the other's shoes gives the paying party all the rights of the shoe owner. So, the party wearing the shoes may assert any claims or defenses that the original shoe owner could assert.

Under a valid waiver of subrogation, the waiving party may not transfer its rights to assert a claim or defense to another entity. The other entity is typically the insurer. The waiving party is typically the insured. Waivers of subrogation shift the risk of loss to the insurer and are generally valid if done before the loss occurs.

A contractor, subcontractor, owner or other entity may benefit as a third party to a contract without being a named party to that contract. The named parties to the contract must have intended to benefit either the unnamed party or an identifiable group of which the unnamed party is a member.

Examples

Two recent cases from Pennsylvania and Missouri illustrate the intersection of these concepts and the potential effects of subrogation waivers upon insurers and third-party beneficiaries.

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In *Community Association Underwriters of America, Inc. v. Rhodes Development Group, Inc.*, 2011 U.S. Dist. Lexis 83403 (M.D. Pa., July 29, 2011), the court found that a condo association was a third-party beneficiary and thus entitled to benefit from the prior owner's waiver of subrogation. In *Rhodes*, the original owner waived its subrogation rights by a contract, which incorporated the AIA (A201) General Conditions. Article 11.3.7 of the A201 (2007) is a standard waiver of subrogation that is frequently used between parties and routinely upheld by courts. After the waiver, the owner transferred the property along with the subrogation waiver to a condo association. Although the condo association was not a party to the actual waiver, the court found it was a third-party beneficiary.

Later, the property suffered fire damage allegedly caused by the drywall contractors' heaters. The insurer paid the condo association's claims and sued the drywall contractors for negligence. The insurer tried to step into the condo association's shoes (*i.e.* subrogation) by paying the claims. However, the condo association had no subrogation rights (*i.e.* no shoes to step into) because the previous owner had waived subrogation. As such, the insurer could not pursue the drywall subcontractors in court.

Another recent case in Missouri involved a similar waiver of subrogation. In *RLI Insurance Co. v. Southern Union Co.*, 341 S.W.3d 821 (Mo. Ct. App., May 31, 2011), the insurer again was the losing party. After paying the owner's claims after a gas explosion and fire, the insurer tried to step into the owner's shoes, but again there were no shoes to step into because the owner had waived subrogation. Again, it was a third party, like the condo association in *Rhodes*, which benefited from the subrogation waiver. This time, however, the third-party beneficiary was not a successor to the owner, but was one of the owner's other contractors.

In *RLI*, the owner waived subrogation with several contractors by a contract that incorporated the standard A201 waiver. Later, the owner contracted directly with a gas contractor. The contract between the owner and gas contractor did not include a subrogation waiver. Nevertheless, the court reasoned that the gas contractor was a third-party beneficiary because it was a member of the identifiable group (*i.e.* all the other contractors) that the owner had intended to benefit by waiving subrogation. As a third-party beneficiary, the gas contractor successfully asserted the subrogation waiver as a defense.

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The results of these two cases may seem counterintuitive because the owner and contractor defended claims with provisions of contracts to which neither were parties. However, as the commentary to the A201 2007 revisions to A201 make clear, since the purpose of the subrogation waiver is to shift the risk of loss to the insurer, "it would defeat this purpose if the insurance company were allowed to sue either party to recover such losses."

Bottom Line: Whether defending or pursuing claims, consider if a subrogation waiver applies and if it can be asserted as a defense or be a potential hurdle to overcome.

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