



2015 CLM Annual Conference
Palm Desert

Non-Conforming Coverage Remedies and Extra-Contractual Considerations

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Overview

Once upon a time, the contractual transfer of risk between insured parties was accomplished somewhat easily by means of additional insured endorsements. Then, as now, many contracts in the construction, temporary services, products supply and commercial leasing contexts required the risk-assuming party to protect the beneficiary for losses *arising out of* the relationship or the associated work. There was then a happy symmetry between the scope of the risk being assumed and the coverage available to support it. So from the mid-Eighties until 2004, parties seldom experienced concerns about the applicability of the indemnitor's coverage because the additional insured (AI) endorsements commonly available absorbed liability for losses arising out of the named insured's work for the additional insured.

Carriers began to express dissatisfaction with the fact that the coverage created by the AI endorsements mandated acceptance of loss expense and indemnity dollars for liabilities largely, if not exclusively, created by additional insureds over whom the carriers had no underwriting control. Often the risk transfers prohibited by state anti-indemnity statutes were nonetheless passed along to the downstream insurer because there was nothing in the AI endorsements limiting that coverage was only co-extensive with what the contracting parties could allocate among themselves according to local law. Moreover, the "arising out of trigger" doesn't require fault or causation: the mere relationship of the involved parties could be enough to meet the broad reach most courts conferred on the phrase (e.g., a claim by a subcontractor's employee -- having no fault -- injured by a general contractor's reckless operation of equipment would generally be deemed within the coverage afforded by the subcontractor's general liability insurer). Consequently, carriers for construction subcontractors, commercial tenants and product distributors would frequently be forced to adjust, defend, settle or take to judgment claims based solely on the negligent conduct of the additional insured.

Notwithstanding the sometime incongruous results imposed by the application of the broad AI endorsement, which arguably evaded the public policy objectives of anti-indemnity statutes, courts generally construed the insuring and indemnity obligations to be separate, thus having no effect on how the subcontractor's grant of AI protection would apply.

The Insurance Services Office, Inc. (ISO) began to respond to concerns raised by carriers in the early 2000s. The first substantial change in the standard AI form -- published in 2001 -- was temporal: different endorsements were required to protect additional insured for ongoing and for completed operations. This amendment afforded greater protection against the defense cost and liability exposures created by, *inter alia*, construction defect litigation.

The move to narrow the reach of the AI forms to loss scenarios in which the named insured had little or no causative role was accomplished with the publication of a modified AI endorsement in 2004. The broad “arising out of trigger” was replaced with the requirement that the occurrence falling within the endorsement’s reach be “caused by, in whole or in part” the named insured’s (e.g., subcontractor’s) work. Consequently, reference to the general relationship between the contracting parties was insufficient to trigger AI protection: some causation on the part of the named insured need be alleged or demonstrated for its carrier to be obliged to enact a defense or cover the additional insured. This modification created an extraordinary change in claim handling, as the question of whether the AI-providing insurer needed to step-in and defend the additional insured became more fact-intensive and something of a judgment call. Indeed, the courts have wrestled with the significance of the more restrictive trigger. Even ten years after the 2004 forms hit the market, there is little precedent setting the parameters of causation in the AI context. More importantly, no consensus has emerged, so the meaning and reach of the newer causation trigger will differ substantially among jurisdictions, making underwriting and claim handling more complicated and less certain.

While the meaning and effects of the ISO 2004 AI endorsement amendments have yet to be settled, ISO has inserted another AI form into the market that is intended to protect carriers in a manner that, perhaps for the first time, merges the concepts of “insured contract” with “additional insured” status. ISO published revisions to a number of its coverage forms and endorsements, including its Additional Insured Endorsements, in April 2013. The latest iteration of the ISO Additional Insured forms represent the most substantial change yet in the extent to which AI coverage extends to contractual commitments to designate parties as additional insureds.

The traditional thinking has been that a party qualified as an additional insured was entitled to the same coverage as the named insured, subject to the policy limits and exclusions. In other words, absent policy language to the contrary, coverage was generally governed by the named insured’s policy terms, not the contract between the named insured and the additional insured. Under the ISO’s 2013 revisions to additional insured endorsements, however, the parties’ contract dictates the scope of coverage provided to the additional insured, in disregard of the familiar maxim that “the policy speaks for itself (i.e., the contract between insured parties doesn’t affect the application of the policy -- which remains the superior and only governing instrument).

Indemnity Provisions in Construction Contracts

Construction contracts almost invariably require subcontractors to indemnify upstream parties (e.g., developers, owners and general contractors) for bodily injury, property damage and other claims or losses that arise out of the downstream party’s work. The breadth of the indemnification provisions vary. While some provisions state that the indemnitor is liable for its own negligence only, others are not as broad, and may require indemnification for the indemnitee’s own or even sole negligence.

The common indemnity clauses are often classified as broad, intermediate, and limited. Broad indemnity clauses provide that an indemnitee is protected by an indemnitor for losses “whether caused by the acts or omissions including the sole negligence of the indemnitee.” These clauses are often voided by state jurisprudence or statutes. Intermediate indemnity clauses are triggered where the loss is “caused by, in whole or in part...” or “except for loss caused by the sole negligence of” the indemnitee. These clauses are seldom disturbed by the courts. Limited indemnity clauses apply to any loss resulting from an indemnitor’s acts or omissions, but only to the proportional extent of that negligence. Limited indemnity clauses contain phrases such as “to the extent” or “indemnify each other.” These clauses are desirable from the perspective of indemnitors, but they often create finger pointing and discord among the contracting parties when losses occur.

ISO’s Additional Insured Endorsement Evolution

The evolution of ISO Additional Insured Coverage began in 1985 in Form CG 20 10 (11 85), where additional insured coverage for the person or organization is shown in the Schedule of a Named Insured’s policy was triggered only “to liability arising out of ‘your work’ for that insured by or for you.” The 1993 editions of Form CG 20 10 (10 93) added the concept of ongoing operations to the additional insured coverage limitation. Then, in 2001, there were two significant changes to additional insured coverage; namely, Form CG 20 10 (10 01) amended the definition of insured to limit additional insured coverage for “liability arising out of your ongoing operations performed for that insured.” and Form CG 20 37 (10 01) reinstated completed operations coverage for “liability arising out of ‘your work’ at the location designated and described in the Schedule of this endorsement performed for that insured and included in the products-completed operations hazard.” In 2004, Form CG 20 10 (07 04) introduced a causal connection between the named insured’s action or omissions and the additional insured’s liability, limiting additional insured coverage to injuries “caused in whole or in part” by the named insured’s acts or omissions or the acts or omissions of those acting on behalf of the named insured in the performance of ongoing operations for the additional insured. Of note, Form CG 37 (07 04) kept the completed operations coverage.

New Limitations in the ISO 2013 Additional Insured Endorsements

The ISO 2013 ALE modifies its application in three new ways that will change the way contracting parties can rely on AIEs as solving risk allocation. Specifically, this ALE specifies that: (1) it affords protection only “to the extent permitted by law”; (2) coverage thereunder “will not be broader” than the contract requires; and (3) the limits available to the additional insured are “the lesser of the contract requirement or the policy declaration.”

A. Coverage is Provided “To the Extent Provided by Law”

In an apparent effort to avoid the assumption of coverage responsibilities under contracts that otherwise void under anti-indemnity statutes, the ISO 2013 ALE seeks to void its application where such risk transfer violates applicable law. For example, the new *Additional Insured-Owners, Lessees or Contractors-Scheduled Person or Organization* (CG 20 10 04 13) endorsement states:

A. Section II-Who Is An Insured is amended to include as an additional insured the person(s) or organization(s) shown in the Schedule, but only with respect to liability for “bodily injury”, “property damage” or “personal and advertising injury” caused, in whole or part, by:

- (1) Your acts or omissions; or

(2) The acts or omissions of those acting on your behalf in the performance your ongoing operations for the additional insured(s) at the location(s) designated above.

However:

1. *The insurance afforded to such additional insured only applies to the extent permitted by law. (Emphasis added.)*

The italicized terms are an effort to recognize the ostensible impact of the anti-indemnification in force in most of states that restrict, modify, or invalidate indemnification agreements in construction contracts. These statutes and associated case law frequently prohibit the transfer of an indemnitee's sole and/or concurrent negligence through indemnity clauses. Even where the anti-indemnification statute would render a contractual indemnification provision unenforceable, however, many courts have declared that defense or insuring obligations are unaffected. As a result, the indemnitees may get the full bundle of rights under the more familiar (and pre-2013) ALEs even if the contract itself is defective.

ISO's new ALE may be read to harmonize, without the need for state specific endorsements, the scope of coverage that anti-indemnification laws extend to additional insureds, at least in those jurisdictions where the legislature or courts have declared that the pledge of coverage fails where the contract is void as against public policy. This change represents an extraordinary reversal of how ALEs have traditionally patched holes in risk transfer scenarios when contract terms are potentially offensive to law or are ambiguous in application. Unless parties promptly amend their CRT provisions, indemnitees will be left without the expected coverage and indemnitors will be exposed to breach of contract claims that generally regarded to be non-covered transactions not causing property damage.

B. Coverage "Will Not Be Broader Than" the Contract Requires

The second modification ISO 2013 has made is to restrict the applicable features of AI protection to the specific requirements of the parties' contract. The traditional approach under ISO forms was that the AI earned the full bundle of rights conferred on omnibus insureds under the policy (e.g., defense, supplemental pay benefits). The ISO 2013 AIE abandons the long-held notion that an insured's contract cannot affect the scope of coverage. So as to limit the range and scope of protection to what was specifically conferred by contract on the AI, the new ALE declares that what is afforded to the additional insured under the policy "will not be broader than" the coverage that the named insured is required by contract or agreement to provide.

One form employing this concept is the new *Additional Insured-Owners, Lessees or Contractors-Completed Operations* (CG 20 37 04 13) endorsement:

A. Section II-Who Is An Insured is amended to include as an additional insured the person(s) or organization(s) shown in the Schedule, but only with respect to liability for "bodily injury" or "property damage" caused, in whole or in part, by "your work" at the location designated and described in the Schedule of this endorsement performed for that additional insured and included in the "products-completed operation hazard."

However:

2. *If coverage provided to the additional insured is required by a contract or agreement, the insurance afforded to such additional insured will not be broader than*

that which you are required by the contract or agreement to provide for such additional insured. (Emphasis added)

Contracting parties can no longer rest easy that making the CRT beneficiary an AI will protect each other from direct financial loss via CGL coverage. The contract terms now dictate how and to the extent the AI coverage applies. The parties' contract language should make clear their intent regarding the scope of additional insured coverage, with specific reference to the elements comprising the familiar rights bundle held by omnibus insureds. Insurance claims analysts will now analyze and construe the underlying contract to determine scope and degree of coverage to which the AI is entitled.

C. Limits are the Lesser of Contract Requirement or the Policy Declarations

The change brought on by the ISO 2013 ALE that is easiest to determine (and navigate by contract updating) concerns applicable limits. The new form states that the most the insurer will pay on the behalf of the additional insured is either: (1) the amount "[r]equired by the contract or agreement;" or (2) the "applicable Limits of Insurance shown in the Declarations, whichever is less." For example, the new *Additional Insured-Designated Person or Organization* form (CG 20 26 04 13), states:

B. With respect to insurance afforded to these additional insureds, the following is added to Section III-Limits Of Insurance:

If coverage provided to the additional insured is required by a contract or agreement, the most *we will pay on behalf of the additional insured is the amount of insurance:*

1. *Required by the contract or agreement; or*
2. *Available under the applicable Limits of Insurance shown in the Declarations; whichever is less.*

This endorsement shall not increase applicable Limits of Insurance shown in the declarations. (Emphasis added.)

Under the 2013 ISO AIE revisions, the most an insurer will pay on behalf of the additional insured is the sum required by the underlying agreement, or the amount of insurance available under the policy limits, *whichever is less*. The intent here is to limit the insurer's exposure to the contracting parties' expectations. In other words, a party demanding AI status and limits of a particular amount won't get a windfall of protection should the named insured have procured greater limits. To some extent this seems fair, as the additional insured otherwise would be getting more than it bargained for. Under this particular example of how the scope of the additional insured coverage is tied to the underlying contract, commercial landlords and other contract beneficiaries still utilizing older contract forms may be in for an unpleasant surprise: the monetary requirements in long-running leases or other form agreements are often far less than what is customarily procured by 2014-2015 commercial standards. In fact, many lease forms real estate lawyers still employ on *new* leases require "Comprehensive Public Liability Insurance," a coverage format that hasn't been available for about 30 years. Those same leases and form contracts may require only \$300,000 or \$500,000 in liability limits, so the 2013 ISO AIE will restrict the additional insured's coverage to whatever amount is called for by the contract if it is less than what is established by the declarations page.

One trap for the unwary here is that the additional insured may consequently have a gap in coverage between what is conferred by its contract partner and its own general liability or excess policy.

D. New Blanket Additional Insured Endorsement

Many ALEs available in the market provide that the person or organization for whom the named insured is performing operations will qualify as an additional insured “when you and such person or organization have agreed in writing in a contract or agreement that such person or organization be added as an additional insured on your policy.” The “such person” reference has created uninsured exposures where a downstream party agrees to name an upstream party as additional insured when there is no executed contract between the two parties. In many cases, for examples, the subcontractor has privity with the general contractor; but it has no direct contract obligation to the owner or developer.

When an additional insured endorsement contains a “such person” clause, the lack of a direct contract between the named insured and the purported additional insured has often been construed to mean that the party not in privity of contract is left unprotected.

One of the 2013 amendments that intends to honor the parties’ expectation in a more expansive and protective manner is found in the new ISO blanket endorsement styled *Additional Insured-Owners, Lessees or Contractors-Automatic Status For Other Parties When Required In Written Construction Agreement* (CG 20 38 04 13). This form provides blanket additional insured status to all parties whom the named insured is required to add as an additional insured under a contract:

A. Section II-Who Is An Insured is amended to include as an additional insured:

1. Any person or organization for whom you are performing operations when you and such person or organization have agreed in writing in a contract or agreement that such person or organization be added as an additional insured on your policy; and
2. ***Any other person or organization you are required to add as an additional insured under the contract or agreement described in Paragraph 1 above.***

Such person(s) or organization(s) is an additional insured only with respect to liability for “bodily injury,” “property damage” or “personal and advertising injury” caused, in whole or in part, by:

- a. your acts of omissions; or
- b. the acts or omissions of those acting on your behalf; in the performance of your ongoing operations for the additional insured.

(Emphasis added.)

This endorsement serves to protect all parties as to which the named insured agrees in writing to provide AI coverage, regardless whether there is privity between them.

E. New “Other Insurance” Condition Endorsement

As part of its 2013 revisions, ISO has also introduced an endorsement that enables brokers and their clients to ensure the intended order of coverage primacy is recognized. The form entitled *Primary and Noncontributory -- Other Insurance Condition* (CG 20 01 04 13) revises the “Other Insured Condition” to state that coverage made available to an additional insured is provided on a primary and noncontributory basis where the named insured has agreed to do so in writing.

This is a new form altogether which states:

The following is added to the Other Insurance Condition and supersedes any provision to the contrary:

Primary and Noncontributory Insurance

This insurance is primary to and will not seek contribution from any other insurance available to an additional insured under your policy provided that:

- (1) The additional insured is a Named Insured under such other insurance; and

(2) You have agreed in writing in a contract or agreement that this insurance would be primary and would not seek contribution from any other insurance available to the additional insured.

(Emphasis Added).

For many years carriers waged battle as to the AI's concurrent coverage. Insurers developed imaginative "other insurance" clauses so that they could declare their coverage excess to whatever was held by the AI--the contract intent notwithstanding. Indeed, many insurers insert excess, diminution and escape clauses in their AIE forms that make the AI protection they claim to afford wholly illusory. ISO leveled the playing field when is introduced

One reason an indemnitee bargains for additional insured status is to preserve its own insurance. This is especially important to general contractors because their aggregates are exposed to bodily injury claims by subcontractors' employees. Parties and their insurance brokers began to impose the requirement that the downstream contractors' CGL and its associated AIE be "primary and non-contributory" to that of the AI. The intent of this reference is to ensure that the AI's (or general contractor's) direct coverage is not tapped until the limits of the indemnitor's policy is exhausted. A secondary reason for the inclusion of this phrase is to impose the defense obligation on the indemnitor's insurer (as the carrier having the primary coverage is generally bound to defend—with secondary or excess-level carriers excused from that duty until limits exhaustion). Also, if there is excess insurance that "follows form" to the primary insurance of the indemnitor, it may provide coverage prior to an indemnitee's primary insurer. This new form clarifies the intent of the parties where the parties contain wording in the contract requiring coverage be extended to the additional insured on a primary and non-contributory basis.

F. Revision to the "Insured Contract" Definition

Standard CGL policies often exclude coverage for contractual liability claims against the policy holder, that is, damages "for which the insured is obligated to pay by reason of the assumption of liability in a contract or agreement." However, the "insured contract" exception to the contractual liability exclusion extends coverage for contracts in which the insured has assumed the tort liability of another entity. This interplay between the "insured contract" exception and state statutes prohibiting a contract that indemnifies another entity for its own fault has led to coverage issues where courts have held that the invalidity of a contract whereby the indemnitor assumes the liability for the fault of the indemnitee does not affect the construction of the "insured contract" exception in CGL policies and found coverage under CGL policies.

In response, in the 2013 revisions, ISO revised its definition of "insured contract" in *Amendments of Insured Contract Definition* (CG 24 26 04 13) endorsement, to amend Paragraph f of the definition of "insured contract" as follows:

The definition of "insured contract" in the **Definitions** section is replaced by the following:

"Insured contract" means:

f. that part of any other contract or agreement pertaining to your business...under which you assume the tort liability of another party to pay for "bodily injury" or "property damages" to a third person or organization, provided the "bodily injury" or "property damage" is caused, in whole or in part, by you or by those acting on your behalf. *However, such part of a contract or agreement shall only be considered an "insured contract" to the extent your assumption of tort liability is*

permitted by law.” Tort liability means a liability that would be imposed by law in the absence of any contract or agreement.

(Emphasis Added).

GOING FORWARD

The changes to the AIE made by ISO in the 2004 edition led to a greater number of tenders to be rejected or made subject to reservations of rights. The former has stirred coverage litigation; the latter encourages affected contractors to engage independent counsel to defend suits pursuant to the *Cumis* doctrine. Some scenarios involve both a declaratory judgment action and a defense enacted by the additional insured’s selected counsel, increasing carrier adjusting loss expense. There have been relatively few court decisions on the scope and meaning of the 2004 AIE, and certainly no consensus.

There is little question but that the ISO 2013 AIE form will generate a greater level of controversy and coverage disputes. As the contract terms may be employed by carriers to narrow the scope or amount of AI coverage, claims professional will be called upon to scrutinize the involved contract and policy to determine how, where and to what extent contract provisions interact with and minimize the scope of coverage. That commercial contracts and insurance policies resort to different terms, phrases and words of art will pose challenges in reconciling the two.

All parties to contractual risk transfer are well-advised to consider the changing marketplace for AI protection when negotiating loss allocation. In the meantime, there will be disappointment and disputes that arise from the common disconnect between contract requirements and causation triggers on the one hand, and AIE limitations on the other.

Parties in higher risk industries are generally cognizant of the importance of drafting aggressive CRT provisions on their subcontractors, vendors and service providers. For this segment, it has long been the practice to demand that providers provide coverage on a “primary and non-contributory” basis. Employment of the new “Primary and Noncontributory—Other Insurance Condition” endorsement will minimize the frequency of disputes on which policy pays first. There will be many circumstances, however, when that form is unavailable (due to a carrier’s non-adherence to ISO forms or a conscious decision not to permit the form to issue on certain risks). Other times the endorsement isn’t issued due to inattention or neglect. The question will become whether its absence has a material effect on how the coverage flows.

The better practice for parties demanding CRT in high exposure endeavors is to specify the insurance policy forms required. There are situations when the vendor cannot procure the particular AIE or other form, particularly when they are insured by a carrier not utilizing ISO forms. An alternative is sometimes permitted by the beneficiary to the effect that, where a specific form is not available, the vendor must secure an “equivalent.” Given the several changes created by the IOS 2103 AIE, there will likely be considerable litigation over the meaning of “equivalent” forms or coverage. These disputes will involve not only the causation trigger, but also the parts of the omnibus insured bundle and policy limits because the traditional AIEs don’t carve out protections or limit based on contract content.

Parties aggrieved by deficient coverage will have several targets. The most obvious is the subcontractor/vendor which was obliged to get specific protection. Depending on the relationship, the beneficiary will have practical and legal avenues. For example, general contractors may hold-back sums due subcontractors on ongoing projects. Commercial lessors may impose added fees or procure the desired coverage and charge-back the tenant. When the failure to obtain coverage responsive to a loss has substantial consequences, the landlord may well commence eviction if the omission constitutes a material breach of the lease. Under these

circumstances, claims professionals are often haunted by agents and brokers demanding resolution in favor of the upstream party so that their downstream insured-client isn't affected financially.

Agents and brokers have a more personal reason to nudge insurers toward accepting AI tenders otherwise subject to restrictions or limitations: their policyholder-client look to them for guidance and protection in securing coverage that is adequate in limits and scope, as well as compliant with their CRT commitments. Agents/brokers are often called upon to review contract proposals, evaluate coverage compliance and issue certificates used by their clients to prove conforming coverage. Disappointed CRT beneficiaries can be expected to pursue claims against their provider's agents/brokers for misrepresentation, and/or to take assignments of E&O rights by the providers themselves, for the breach of a promise to procure specific insurance does not constitute a covered claim.

Beneficiaries looking for remedies for non-compliant coverage may have grounds for relief against insurers under certain circumstances. The most familiar avenue is under the doctrine of reasonable expectations. Pressing this theory is most effective when asserted by the purchasing insured—as it has standing to say the carrier's policy terms or marketing led it to conclude there was coverage in spite of terms to the contrary. Once again, the beneficiary would do well to take an assignment of its provider's rights as part of a settlement for non-compliant coverage. Under rare circumstances, a beneficiary may get the desired coverage relief by reference to statutory, regulatory or public bid insurance requirements. Some courts have deemed insurers to be aware of and be bound by the sorts of risks their insured undertake, and therefore impute coverage when none otherwise exists.

Carriers employing the ISO 2013 AIE would do well to use care in the marketing of their CGL policies to industry segments commonly requiring CRT. Even two years post-publication of the new AIE, many insurance purchasers and their agents/brokers are unaware of the potential consequences of its use and the exposures that can result.

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The author gratefully acknowledges the contributions of Francine Guigno, PATRICK, MILLER, New Orleans, in developing an earlier version of this summary.

It is important for contracting parties to pay close attention to the applicable law in their jurisdiction, including applicable anti-indemnification statutes, and the underlying contractual provisions setting forth the scope of contractual indemnification and additional insured requirements. Also, contracting parties are advised to review the specific terms of the insurance policies under which additional insured protection is to be afforded, including all endorsements, to confirm coverage terms and to understand the interplay between the underlying contract provisions and the additional insured coverage so as to avoid unpleasant surprises such as gaps or potential loss of insurance coverage.