



CGL ISSUES AND DEVELOPMENTS

CONTRACTUAL LIABILITY


Presented by

Jill B. Berkeley
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CGL

The commercial general liability policy is a cornerstone of a contractor's insurance program. It is in reference to this policy that the majority of construction insurance disputes are litigated. Because of the complexity of construction claims and the constantly evolving case law relating to the CGL policy, those on both sides of the fence (insurer and insured) often misunderstand even some of the basic coverages. Coverage disputes are the inevitable result. This session will provide an overview of case law on the scope of key CGL coverages for construction risks, including contractual liability coverage, coverage for construction defects, and coverage for additional insureds. A construction broker and underwriter will offer strategies for avoiding coverage gaps and modifying problematic provisions in a way that maximizes the value of the insurance to the contractor.

Monday, November 13, 9:00 a.m.–5:00 p.m.



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Ms. Berkeley is one of the presenters for Monday's all-day seminar, "CGL Issues and Developments." She is a partner at Schiff Hardin & Waite in Chicago and heads the firm's Insurance Group. Her representation of insurers and insureds includes declaratory judgments, bad faith, toxic tort and hazardous wastes, and excess liability matters. In addition to litigation, she has consulted with numerous clients on issues of coverage and risk management under all forms of policies including auto, CGL, workers compensation, property, directors and officers liability, and professional liability. She has extensive experience in the review and drafting of policy forms and endorsements.

Reported decisions of cases that she tried or participated in include *Roman Catholic Diocese of Springfield in Illinois v Maryland Casualty Company*, 139 F3d 561 (7th Cir 1998); *American States Ins. Co. v Koloms*, 666 NE2d 699 (Ill App 1996), aff'd 687 NE2d 72 (Ill 1997); *Rhone-Poulenc v International Insurance Company*, 71 F3d 1299 (7th Cir 1995); *Carbone v American Bankers Insurance Company*, Rule 23 Decision (Ill App 5th Dist 1995); *Old Republic Insurance Company v Meadows Indemnity Company, Ltd.*, 870 F Supp 210 (ND Ill 1994); *Aetna Ins. Co. v Chicago Ins. Co.*, 994 F2d 1254 (7th Cir 1993); *Coronet Ins. Co. v Saez*, 502 NE2d 1292 (Ill App 1987); *Evaluation Systems, Inc., v Aetna Life Ins. Co.*, 555 F Supp 116 (ND Ill 1982); *Allstate Ins. Co. v Gutenkauf*, 431 NE2d 1282 (Ill App 1981); *Martin v Allstate Ins. Co.*, 416 NE2d 347 (Ill App 1981); *Scroggins v Allstate Ins. Co.*, 393 NE2d 718 (Ill App 1979).

Since August 1986, Ms. Berkeley has been the principal author and executive editor of *CGL Reporter*, published by International Risk Management Institute, Inc. She has also been widely published on insurance, self-insurance, and risk management issues. Ms. Berkeley is active in the American Bar Association, the National Risk Retention Association, the Illinois Captive & Alternative Risk Funding Insurance Association, and the Association of Professional Insurance Women. She received her J.D. degree from Northwestern University in 1975 and her B.A., *magna cum laude*, from the University of Michigan and was elected to Phi Beta Kappa in 1972.

Notes

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CONTRACTUAL LIABILITY

*Jill B. Berkeley
Schiff Hardin & Waite*

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Overview

- Basics
- Start with policy and examination of coverage – then look at the factual situations
- More Complicated Situations
- Creative Uses To Expand the Coverage
- **Written Materials**
 - New article as an update to paper prepared in 1998
 - Sequel to Six Myths

www.schiffhardin.com/practice/p_insurance_articles.html

Basics

- Contractual Liability Coverage in relation to other risk-shifting mechanisms
 - Additional insured endorsements
 - Contractual indemnity
- Tool against the insurer of the indemnitor
- Use by indemnitee in cooperation with indemnitor
- Effect intent of the parties to have indemnitor's insurer bear the risk

Insuring Agreement:

The company will pay on behalf of the insured all sums which the insured shall become legally obligated to pay as damages because of bodily injury or property damage to which this insurance applies, caused by an occurrence.

Scope of Coverage of Insuring Agreement

- Indemnity constitutes “legally obligated to pay as damages”
- Promise to hold harmless for
 - Bodily injury
 - Property damage
 - If caused by an occurrence

Insuring Agreement

Bodily Injury/
Property Damage

- Gives coverage for bodily injury and property damage

Exclusion for Contractual Liability

- **MISNOMER**
- Exclusion for assumption of liability
- Coverage for Insured Contracts:
not coverage for breach of contract

Exclusion for Contractual Liability

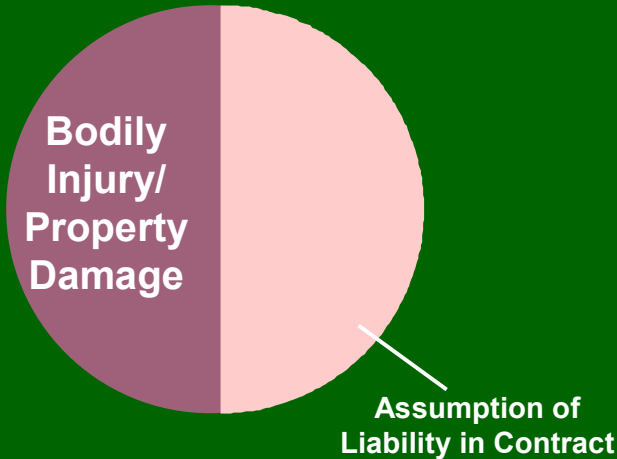
- **“BREACH OF CONTRACT” IS DIFFERENT FROM LIABILITY FOR BODILY INJURY OR PROPERTY DAMAGE ASSUMED UNDER CONTRACT**
 - Vandenberg v. Superior Court: damages arising from breach of contract can be covered
 - Contract Damages Are Economic Loss
 - Measure of Benefit of the Bargain

Exclusion for Contractual Liability

This insurance does not apply to: ...
“bodily injury” or “property damage” for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement.

- “Takes Away” coverage for damages legally obligated to pay by reason of the “assumption of liability in a contract”

Exclusion for Contractual Liability

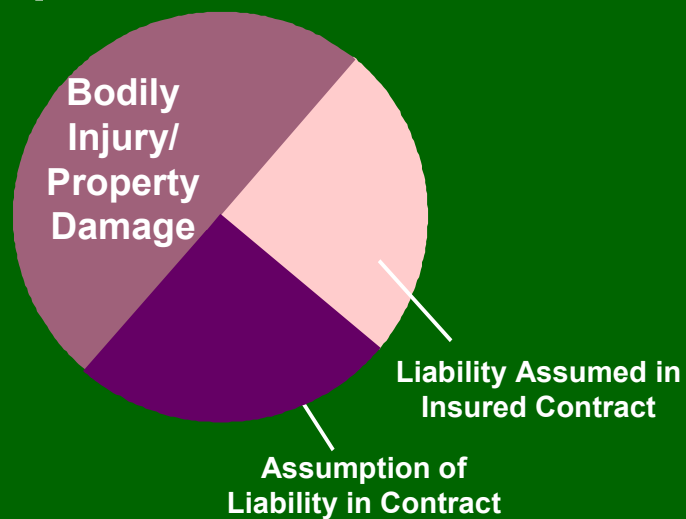


Exception to Exclusion

This exclusion does not apply to liability for damages ... assumed in a contract or agreement that is an insured contract.

- “Gives back” a portion of what the exclusion “takes away”
- Also used as exception to “employee exclusion”

Exception to Exclusion



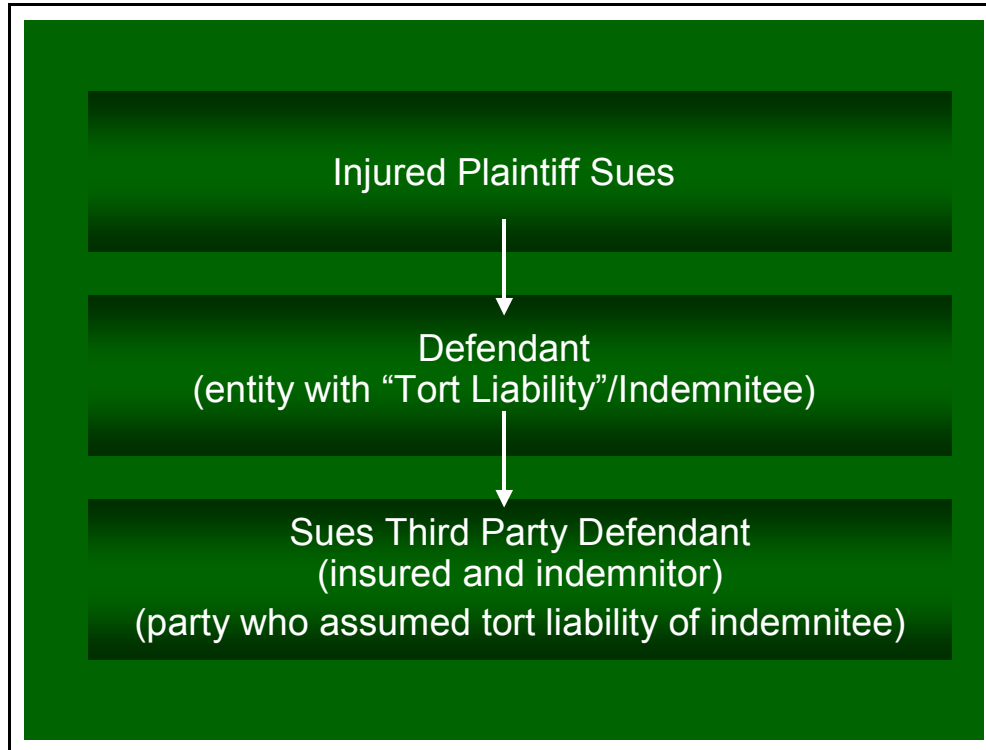
Definition of Insured Contract

That part of any other contract or agreement pertaining to your business (including an indemnification of a municipality in connection with work performed for a municipality) under which you assume the tort liability of another party to pay for “bodily injury” or “property damage” to a third person or organization. Tort liability means a liability that would be imposed by law in the absence of any contract or agreement.

Definition of Insured Contract

That part of any other contract or agreement pertaining to your business (including an indemnification of a municipality in connection with work performed for a municipality) under which you assume the tort liability of another party to pay for “bodily injury” or “property damage” to a third person or organization. Tort liability means a liability that would be imposed by law in the absence of any contract or agreement.

- part of a contract or agreement
- pertaining to your business (“your”=named insured)
- under which you assume (“you”=named insured= indemnitor)
- the tort liability
- of another party (indemnatee)
- to pay for “bodily injury” or “property damage”
- to a third person or organization (claimant)



Definition of Insured Contract

- Tort Liability
 - Usually thought to mean negligence
 - Negligence is too narrow
 - Could be vicarious liability
 - Could be strict liability, for example, Illinois Structural Work Act
 - What if ultimately not liable

Example of General Contractor/Subcontractor

Subcontractor agrees to indemnify general contractor for injury or damage to a third party
(in contract)

Third party injured on site allegedly due to work of subcontractor, but general contractor sued

(why? Employer protected by WC exclusivity rule; deep pocket approach; “named insured work” exclusion in construction defect case)

Example of General Contractor/Subcontractor

General contractor asserts enforceable indemnity action against subcontractor
(necessary for trigger of coverage and for ultimate collection)


Subcontractor is covered for defense and indemnity

General contractor’s defense costs and indemnity constitute damages

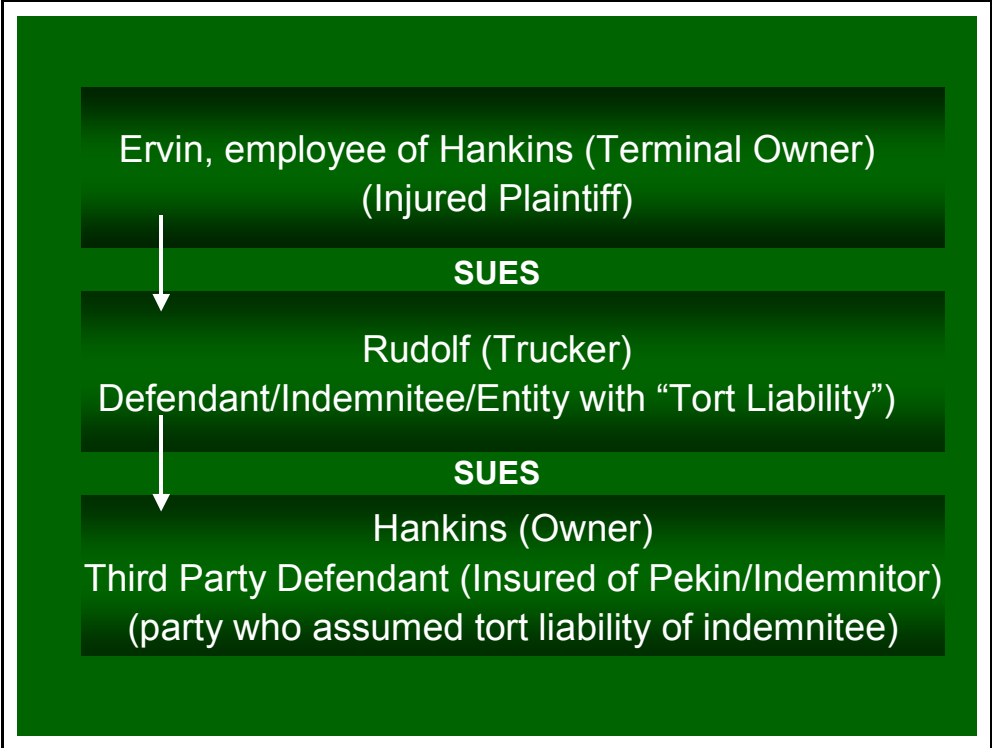
Example – Lessee of Trucker/Owner of Truck

- Lessee of Truck (indemnitor) agrees to indemnify the owner-lessor (indemnatee) under lease/contract
- damage arising from use of truck
- third party property damage sustained by use of truck
- owner sued for failure to maintain brakes; asserts indemnity
- ENFORCEABLE if owner's tort liability meets policy definition
- Same limits as per occurrence BI/PD
- Trucker gets a defense in the action over

Example – Lessee of Trucker/Owner of Truck



Useful if trucker was not sued directly or if exposure is greater than indemnatee's own policy



When a Contract is NOT an "Insured Contract"

- "Performance Bond" damages by reason of non-performance
 - Sanders v. Ashland Oil (Louisiana)
 - Bernstein v. Consolidated (California)
- Liability for Leasehold Property
 - Old Republic v. Superior Court (California)

When a Contract is NOT an “Insured Contract”

- “Contractual Liability” for damage to rental car
 - Hertz Corp. v. Smith (Pennsylvania)

When a Contract is NOT an “Insured Contract”

- If negligence is excluded from indemnity
 - Allianz Ins. Co. v. Goldcoast Partners (Florida)
 - Hankins v. Pekin Ins. (Illinois)

Avoid this Question:

If promise to indemnify excludes the indemnitee’s negligence, can the promise of indemnity be for “tort liability?”

When a Contract is NOT an “Insured Contract”

- Employer assumed liability for employee’s negligence
 - Based on vicarious liability: no assumption of anything more than imposed by law
 - Lewis v. Hamilton (Louisiana)
- Parent corporation’s guarantee of subsidiary’s tort liability
 - Not related to parent’s business: giving a guarantee not related to business
 - LaFarge Corp. v. Hartford Cas. Ins. Co (Texas)

When a Contract MAY BE an “Insured Contract”

- Waiver of limitations on liability
 - Contractual assumption of liability:
 - Christy-Folz
 - Kotecki limitation
 - Braye waiver

Pitfalls in Arguing for Coverage

- Insurer will confuse liability defenses with coverage defenses
- No tort liability
- Anti-indemnity statute
- Statute of limitations

Pitfalls in Arguing for Coverage

- No insured contract exception to employee exclusion
 - Consolidated Edison Co. v. United Coastal Ins. Co. (New York)
 - Travelers Ind. Co. v. LLJV (New York)
- Indemnitee's defense expenses and costs are damages
 - Beck v. Sitka (Alaska)
 - INA v. National American Ins. Co. (California)

Practical Advice

(a) Hold Harmless. [Indemnitor] agrees to indemnify and hold harmless [Indemnatee] from and against all claims, damages, losses and expenses, including reasonable attorney's fees which might arise out of the performance of any work to be performed hereunder by Indemnitor, including all damages for bodily injury, illness, death, property damage and cargo loss, ...

Practical Advice

... for the liability of Indemnatee **that would be imposed by law in the absence of any contract or agreement** caused in whole or in part by Indemnitor's negligent act or omission or non-compliance with any part of this contract or that of anyone employed by Indemnitor or for whose acts Indemnitor may liable.

Conclusion

- Ambiguity Construed Against Insurer
- Denial of coverage may be the biggest favor an insurer can do for you
- Think “Insured Contract”

HOW TO USE CONTRACTUAL LIABILITY COVERAGE EFFECTIVELY

*Jill B. Berkeley
Schiff Hardin & Waite*

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CGL

Notes

HOW TO USE CONTRACTUAL LIABILITY COVERAGE EFFECTIVELY

by Jill B. Berkeley
Schiff Hardin & Waite

Contractual liability coverage provides a significant source of coverage under the standard ISO commercial general liability policy. The basic purpose of the coverage is to provide insurance for the promise to indemnify another. Beyond the basics,¹ the coverage is potentially available to respond to complicated situations that may not generally fit within other standard provisions. To use the full potential coverage, courts and practitioners need to examine the various facets of the coverage in detail, in order to avoid the traps of misinterpretation.

Summary of How the Coverage Is Provided

Under the broad coverage grant of a CGL policy, an insured is covered for its liability for bodily injury and property damage caused by an occurrence. The insuring agreement, on its own, is broad enough to cover any liability arising from its contractual obligation to indemnify another. The policy language provides:

The company will pay on behalf of the insured all sums which the insured shall become legally obligated to pay as damages because of bodily injury or property damage to which this insurance applies, caused by an occurrence.

¹For background on the basics, see the author's previous article, "Six Myths Concerning Contractual Liability Coverage," *CGL Rep.*, Spring 1995, at 310-5, hereinafter "Six Myths." Also "Contractual Liability Coverage," by Douglas R. Richmond published in DRI's Monograph, *Construction-Related Insurance Coverage Issues* (1997); *Expanding Liability Coverage: Insured Contracts and Additional Insureds*, by Douglas R. Richmond and Darren S. Black, 44 *Drake L. Rev.* 781(1996).

Coverage for "damage" is broad enough to include a suit for indemnification. "Any other conclusion would elevate form over substance and lead to an absurd result." *Hart Construction Co. v. American Family Ins. Mut. Co.*, 514 N.W.2d 384, 390 (N.D. 1994). Thus, the policy without exclusion covers the promise to indemnify.

The standard "contractual liability" exclusion, however, restricts the promise to indemnify.

This insurance does not apply: ... to "bodily injury" or "property damage" for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement.

This exclusion does not apply to liability for damages ... assumed in a contract or agreement that is an insurance contract.

The exclusion "takes away" the coverage provided by the coverage grant. The exception to the exclusion, "does not apply to liability for damages ... assumed in a contract or agreement that is an insured contract," protects the coverage by "giving" it back. By creating an exception to the exclusion, the insurer provides a limited range of contractual liability coverage. The insured becomes obligated to pay under an indemnification agreement that constitutes liability assumed in an "insured contract." *Gibson & Associates, Inc. v. Home Ins. Co.*, 966 F.Supp. 468, 476 (N.D. Tex. 1997). In *Homan Erection Co. v. Employers Ins. of Wausau*, 142 Or. App. 224, 920 P.2d 1125(1996) the Oregon appellate court specifically acknowledged the "liability assumed under contract" exclusion applied in the employer's liability policy to an indemnity action.

“Insured contract” in the ISO 1986 and subsequent CGL policies² is defined as:

“Insured contract” means:

- a. A lease of premises;
- b. A sidetrack agreement;
- c. Any easement or license agreement, except in connection with construction or demolition operations on or within 50 feet of a railroad;
- d. An obligation, as required by ordinance, to indemnify a municipality, except in connection with work for a municipality;
- e. An elevator maintenance agreement;
- f. That part of any other contract or agreement pertaining to your business (including an indemnification of a municipality in connection with work performed for a municipality) under which you assume the tort liability of another party to pay for “bodily injury” or “property damage” to a third person or organization. Tort liability means a liability that would be imposed by law in the absence of any contract or agreement.³

Interpretation of the Exclusion

Strictly speaking, the exclusion would be more aptly named if it were called the “contractual assumption exclusion.” The exclusion does not serve to exclude contractual liability or breach of contract actions.⁴

²In prior ISO editions the exclusion was worded “...to liability assumed by the insured under any contract or agreement except an incidental contract.” In order to “get the coverage back,” the Broad Form Comprehensive General Liability Endorsement (GL 0404) was purchased which provided “Contractual Liability Coverage” by broadening the definition of “incidental contract” to include “any oral or written contract or agreement relating to the conduct of the named insured’s business.”

³There are also four exceptions to the definition of “insured contract” for railroad property, architects, engineers or surveyors, or premises rented or/owned.

In *Townsend Ford, Inc. v. Auto-Owners Ins. Co.*, 656 So.2d 360 (Ala. 1995), the court held that damages arising from a breach of warranty were not excluded by the contractual liability exclusion. Used car salesmen were sued for intentional fraudulent misrepresentation, reckless misrepresentation, and breach of warranty. The court looked at the contractual liability exclusion. It concluded that all liability for damages the insured might be obligated to pay “by reason of the assumption of liability in a contract or agreement was excluded unless it fell within one of the exceptions.” *Townsend*, 656 So.2d at 364. It affirmed the trial court finding that this type of provision “traditionally serve[s] to exclude ‘indemnity’ types of liability, whereby the liability itself was assumed.” It held that a breach of warranty does not involve “the assumption of liability,” but merely a representation. Therefore, since the contractual liability exclusion did not exclude an express warranty, it was covered.

The exclusion was narrowly interpreted in *Gibbs M. Smith, Inc. v. United States Fidelity & Guaranty Co.*, 949 P.2d 337 (Utah 1997). The insured publisher breached its own contract with an author to protect the author’s transparencies used in illustrating a book. The court held that the contractual liability exclusion applied only to contracts in which the insured assumes the tort liability of another. The court agreed with the insurer’s statement:

Courts have over and over again interpreted the phrase ‘liability assumed by the insured under any contract’ to apply only to indemnification and hold-harmless agreements, whereby the insured agrees to ‘assume’ the tort liability of another. *Gibbs M. Smith*, 949 P.2d at 341.

The court, however, refused to apply the exclusion to all liability associated with a contract. “If the contract exclusion clause excluded all liability associated with a contract made by the insured, commercial liability insurance would be severely limited in its coverage.” *Id* at 342.

Contractual liability coverage provides coverage for the tort liabilities of third parties contractually assumed by the insured. Contractual liability coverage *extends* the coverage provided to the insured for another party’s (indemnitee) liability. The other party’s liability may

⁴See Myth 3 of “Six Myths,” *supra*.

arise from its conduct or the conduct of the insured.⁵ Thus, coverage is applicable if the insured is liable for the indemnitee's liability arising out of its (the indemnitee's) conduct or the insured's conduct.

Is There an Insured Contract?

Understanding the definition of "insured contract" begins by distinguishing between a general contract and an "insured contract" or "incidental contract," as defined by the policy. The liability assumed in an incidental or insured contract can refer to any contract or agreement, oral or written, relating to the conduct of the named insured's business. The "incidental contract" is the portion of an agreement "collateral to and independent of the principal agreement," not the principal agreement.⁶

One type of agreement not deemed to be "insured contracts" are performance bonds, often confused with indemnification agreements. In *Sanders v. Ashland Oil, Inc.*, 656 So. 2d 643 (La. Ct. App. 1995), an injured worker and the estate of a deceased worker sued the State of Louisiana, the owner of the construction site, for failure to provide a safe working environment. Their employer had entered a contract with the state that obligated it fully to indemnify and save the state harmless from all costs and damages. Although the contract provided for indemnification, such agreement was in the context of a performance bond and was not really a contract of indemnification for liability. *Sanders*, 656 So.2d at 649. The contract provided:

... should the Contractor herein not perform the contract in accordance with the terms and conditions hereof, or should said Contractor not fully indemnify and save harmless the Owner from all cost and damages which he may suffer by said Contractor's non-performance ... then

⁵*Fireman's Fund Ins. Co. v. National Bank for Cooperatives*, 849 F. Supp. 1347, 1361 (N.D. Cal. 1994).

⁶*Globe Indemnity Co. v. California*, 43 Cal. App.3d 745, 753, 118 Cal.Rptr. 75, 81 (5th dist. 1974), cited in *Fireman's Fund Ins. Co. v. National Bank for Cooperatives*, 849 F.Supp. 1347, 1362 (N.D. Cal. 1994).

said Surety agrees and is bound to so perform the contract and make said payment.

A performance bond was also confused with an indemnity agreement under the contractual liability coverage in a non-ISO form policy. In *Bernstein v. Consolidated American Insurance Co.*, 37 Cal. App. 4th 763, 43 Cal. Rptr. 2d 817 (Cal. App. 2 Dist. 1995), the principal shareholders of a construction subcontractor sued the subcontractor's liability insurer. They alleged that the insurer wrongfully failed to provide the subcontractor with a defense against a claim brought by the subcontractor's surety based on an indemnity agreement. The court held that no coverage existed because the cause of action was for breach of the performance bond, which was a contract claim, not a tort liability claim. The CGL policy contained a "contractual liability" endorsement that expanded the standard insuring agreement to incorporate the definition of an insured contract. The policy provided

... the term 'legally obligated' shall include the named insured's contractual liability, but ONLY with respect to liability of others for such damages assumed by the named insured under a contract which became binding and effective before such damages were sustained.

The court considered the question whether the general contractor's claim against the bonding company sounded in tort or contract.

The relevant inquiry is not the nature of the damages which the City recovered from [the general contractor] and for which [the general contractor] is seeking reimbursement. Rather, the question is on what basis does [the general contractor] claim a right to recover from [the bonding company.]

The answer was clear: the sole premise for the bonding company's liability to the general contractor was the performance bond, a contractual obligation. But for the bonding company's contractual agreement to the general contractor under the performance bond, the general contractor would have no cause of action against the bonding company. "The [bonding company's] liability

to [the general contractor] is not tort liability, arising by operation of law, but contractual liability, based solely on the agreement of the parties.” *Bernstein*, 43 Cal. Rptr.2d at 822.⁷

In *Old Republic v. Superior Court*, 77 Cal. Rptr. 2d 642 (Cal. App. 1998), the California Appellate Court again looked at the difference between an action for breach of contract and an action for liability assumed under contract. The insured, a commercial tenant, was sued for breach of commercial lease and property damage by the owner of the building. The insured tendered its defense to its four commercial liability insurers. While one insurer (“Nautilus”) accepted the defense, three of the insurers (“the insurers”) declined to defend or cover, giving rise to the action before the court. The insurers raised the exclusion for “liability assumed by the insured under any contract or agreement except an incidental contract . . .” Nautilus argued the exception applied for breach of lease “as liability assumed under an incidental contract.” The court rejected this argument holding that the lessees did not assume the liability of another, but rather became liable for the property damage only because of their breach of the lease. Further, because this type of liability was not covered by the CGL policy’s granting clause, coverage could not be created through the exception to the exclusion.

In addition, as the insurers pointed out, the second exclusion would bar coverage. That exclusion provided that the insurance would not apply to “property damage to (1) property owned or occupied by or rented to the insured, . . .” The court noted that even if the CGL policies covered the damages in the original insuring clause, this exclusion would remove these damages, damages to property rented to the insured. Therefore,

⁷In *Vandenberg v. Superior Court*, 21 Cal.4th 815, 982 P.2d 229 (Cal. 1999), the California Supreme Court specifically disagreed with the proposition stated in *Bernstein* that “‘legally obligated’ in contractual liability endorsement only refers to the contractually assumed tort liability of others.” However, the *Vandenberg* court merely rejected the blanket contract/tort comparison. The court held, instead, that coverage is controlled by “the nature of the damage and the risk involved in light of particular policy provisions.” The ultimate holding in *Bernstein* denying coverage may still be reached under the *Vandenberg* analysis. The *Bernstein* sub-contractor’s liability arose because of the performance bond. Because the CGL provisions in *Bernstein* did not provide coverage for contractual claims, *Bernstein*’s holding is still valid.

none of the insurance companies had a duty to defend or cover the insured’s claims.

In *Hertz Corp. v. Smith*, 441 Pa. Super. 575, 657 A.2d 1316 (Pa. Super 1995), the court held that a cause of action for breach of a rental agreement was not covered because the rental agreement did not constitute an insured contract. The customer had damaged the vehicle, and Hertz sued the customer. The court looked at the type of claim in issue. Under the rental agreement, the customer agreed to be contractually responsible for any damage to the rental automobile. The essence of Hertz’s complaint against the customer was for breach of contract. No coverage existed under the customer’s CGL policy for damage to the rental car based on breach of contract. The court noted that the purpose of the insured contract coverage was “to provide benefits for tort liability that an insured contractually assumes, not liability that is based on breach of contract.” *Hertz*, 657 A.2d at 1319.

Another example in which the court limited the definition of “insured contract” turned on the court’s interpretation of the word “assume.” In *Lewis v. Hamilton*, 652 So. 2d 1327 (La. 1995), the court held that an insured’s employment contract with its employee was not an “insured contract” within the meaning of a liability policy.

The definition of ‘assume’ is ‘to take on, become bound as another is bound, or put oneself in place of another as to an obligation of liability.’ *Black’s Law Dictionary* 122 (6th ed. 1990). A second definition is ‘to take upon oneself (the debts or obligations of another).’ *Webster’s New Universal Unabridged Dictionary* 91 (1989). *Lewis*, 652 So.2d at 1330.

Under these definitions, the court held that the word “assume” required some exercise of volition by the insured to undertake or incur liability that did not exist before the assumption. The insured did not assume the tort liability of another under the employment contract since its vicarious liability for its employee’s torts existed by operation of law.

Another court focused on a different portion of the “insured contract” definition in *LaFarge Corp v. Hartford Casualty Insurance Co.*, 61 F.3d 389 (5th Cir. 1995). A CGL insurer sought a declaratory judgment claiming that it had no duty to defend or indemnify its insured. The insured’s subsidiary was charged with breach of contract and breach of warranty claims for defective

pipeline coating. The parent company was sued based upon an alleged surety promise it made on behalf of its subsidiary. The appellate court held that Hartford had no duty to defend when the insured’s liability was predicated solely upon the alleged surety agreement. The policy excluded coverage for liability assumed by contract unless the contract was an “incidental contract.” The portion of the definition the court focused on was the requirement that the contract “relate to the conduct of the named insured business.” The court admitted that the alleged guarantee was for ultimate financial responsibility of the parent company. However, the parent did not supply materials, services, labor, or anything else to the project. Nothing suggested that the parent and subsidiary were anything other than distinct corporate entities. The court rejected the insured’s contention that the guarantee advanced the interest of the parent’s economic well being.

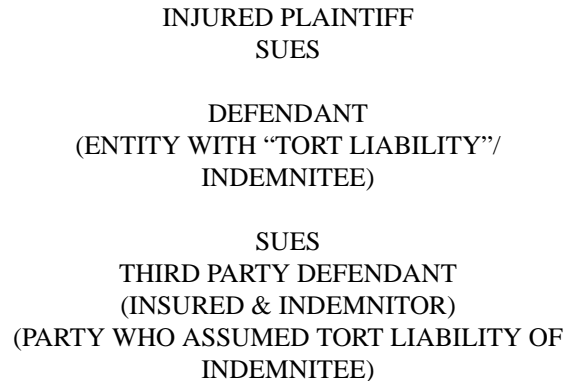
Just as we may not simply assume that the subsidiary’s business is the parent’s business (many subsidiaries are in businesses requiring licenses that their parents do not have), so also we may not assume that conducting the subsidiary’s business is conducting the parent’s business. *LaFarge*, 61 F.3d at 396.

The court concluded that the insured failed to show that the alleged guaranty related to the conduct of the parent’s business. That it related to the conduct of the business of its subsidiary was not enough. Further, it stated that LaFarge’s “interpretation of the [incidental contract] definition would render its relating to the conduct of the insured’s business’ language essentially meaningless.” *Id.* at 397.

What is sufficient to establish an “insured contract?” The insured must overcome many hurdles before it can procure coverage under this provision. The insured contract must be a

- part of a contract or agreement
- pertaining to your business
- under which you assume
- the tort liability [as defined]
- of another party
- to pay for “bodily injury” or “property damage”
- to a third person or organization

The typical diagram of how the “insured contract” coverage works looks like this:



Can Contractual Liability Coverage Expand the Insurer’s Risk?

The various interpretations of “insured contract” lead to an obvious question. If the insured is covered for the contractual assumption of another’s tort liability, will the coverage insure risks that the insured may otherwise not be liable for? The answer is resoundingly, “yes.”

The Louisiana Supreme Court noted that an insured contract requires that liability be “assumed,” which meant something other than liability for which the insured was otherwise liable. In *Lewis, supra*, the court found that the school district was already liable for its employee’s torts committed in the scope of his employment. The insured contract coverage contemplated liability *beyond what it was liable for by operation of law*. This case provides powerful support for the conclusion that the insurer can provide coverage for liability assumed by the insured *beyond its own existing liability*. *Id.*, 652 So.2d at 1330.

Another example of how contractual liability coverage can give an insured broader coverage than it might otherwise have occurred in *Gibson & Assoc., Inc. v. Home Insurance Co.*, 966 F. Supp. 468 (N.D. Tex. 1997). The City of Dallas was sued by several business owners for their financial loss resulting from the closing of a street during construction. The City sued the contractor for breach of contract for failure to perform. The city also sought indemnity for its alleged liability to the business owners. The court held the insurer had no duty to de-

defend the contractor against the breach of contract claim. Texas law does not recognize “lost profits” within the definition of “property damage.” The court also held that a breach of contract did not represent an “occurrence.” The court, however, found that coverage existed for the city’s cause of action based on indemnity. The court held that the business owners’ alleged losses were property damage under the “loss of use” prong of the definition of property damage. Furthermore, the event causing the damage—the closing of the street—did constitute an occurrence. The damage could not be characterized as the “inevitable and predictable” consequence of the contractor’s conduct. *Gibson*, 966 F. Supp at 477.

Other cases have also recently found coverage under the “insured contract” exception, even though the damage may have been excluded by another exclusion. In *BP Oil Co. v. Federated Mutual Insurance Company*, 496 S.E.2d 35 (S.C. App. 1998), the court held that the insured’s liability for contractual indemnity was covered despite the policy’s liquor exclusion.

Courts also recognize that an insured’s liability for indemnity may not be the only cause of action for which it may be liable. In these instances, the insurer’s broad interpretation of the insured contract exclusion has been rejected. In *Atlanta Postal Credit Union v. International Indemnity Company*, 494 S.E.2d 348 (Ga. App. 1997), the insurer argued that because the insured had a contract to perform work repossessing cars that any liability as a result of repossession would be excluded by the insured contract exclusion. The court held that the liability of the reposessor was not dependent on any contractual assumption of liability. The cause of action was based on the indirect, vicarious liability of a master for the torts of his servant. Therefore, the contractual liability exclusion did not apply.

One case to the contrary is *Federal Insurance Company v. Tri-State Insurance Company*, 157 F.3d 800 (10th Cir. 1998), in which the court held that the contractual exclusion did not trump the operations exclusion.

The insured contract definition can provide coverage for risks that are otherwise not covered in another way. Coverage for an indemnitee’s attorneys fees exists, in addition to the damages claimed in the indemnity agreement even though the insurer has no duty to defend the indemnitee.⁸ Courts have found that the costs

⁸See Myth 6, “Six Myths.”

and attorney fees incurred by the indemnitee are considered damages covered by the indemnitor’s policy.⁹

This coverage continues to be valuable, even in light of the 1996 amendments to the ISO form policy. ISO responded to the insurance industry claims that the attorney fees of an indemnitee should be paid as damages. It specifically amended the supplementary payment provision of the CGL to include these fees as “costs.” If one can meet the requirements of the new provisions, the insured benefits by maintaining its limits for indemnity damages. The conditions to trigger the supplementary payments provisions, however, are very limited.¹⁰

Can the Waiver of Limited Liability Be “Liability Assumed under Contract?”

The widespread use of contractual liability coverage has been limited by laws restricting contractual indemnity. Many jurisdictions have ruled that contractual indemnity is void for public policy reasons in construction, in landlord/tenant relationships and certain hazardous industries. Therefore, causes of action for contractual indemnity are not favored and not always allowed. Illinois is a jurisdiction that broadly interprets the ban against indemnity in construction contracts. The Illinois courts, however, have recently created a new cause of action, breathing life into the previously abandoned indemnity cause of action. This new cause of action has also created new demands on the contractual liability coverage, long dormant in Illinois.

Under Illinois law, an employer’s liability to a third-party in contribution is limited to the amount of the Workers’ Compensation benefits paid on behalf of the

⁹See *R. W. Beck & Associates v. City and Borough of Sitka*, et al., 27 F.3d 1475(9th Cir. 1994) (costs and fees incurred by indemnitee that were awarded to him in the contract indemnity suit were damages rather than costs covered by the supplementary payment provisions). See also *Insurance Co. of N. America v. National American Insurance Co.*, 37 Cal. App. 4th 195,43 Cal. Rptr.2d 518 (Cal. App. 4 Dist. 1995) (inference that attorney fees passed through under an indemnity clause were considered damages, in contrast to attorney fees paid under a “prevailing party” clause that were considered “costs.”)

¹⁰See full discussion of 1996 CGL Revisions in *Commercial Liability Insurance*, IV.F.7 et seq., published by the International Risk Management Institute, Inc., 1996.

employer. *Kotecki v. Cyclops Welding Corp.*, 146 Ill.2d 155, 585 N.E.2d 1023 (1991). The supreme court, however, has recently extended the *Kotecki* limitation. *Braye v. Archer-Daniels-Midland Co.*, 175 Ill.2d 201, 676 N.E.2d 1295 (1997); *Liccardi v. Stolt Terminals, Inc.*, 178 Ill.2d 540, 687 N.E.2d 968 (1997). In *Braye*, the court interpreted an indemnity agreement to imply an intent to be liable for *all liability arising from its conduct*. The employer may then have unlimited liability, as opposed to limited liability to the extent of amounts paid or payable under the Worker's Compensation Act. This waiver of the *Kotecki* protection creates "contribution by indemnity." Where *Braye* overrides the *Kotecki* limitation, the waiver can be considered "liability assumed by contract." This liability is excluded under the employer's liability policy and covered under the CGL policy.

In January, 2000, the Illinois Fourth Appellate District held that employers' liability policies do not cover liability assumed through a *Braye* waiver. See *Christy-Foltz, Inc. v. Safety Mutual Casualty Corp.*, 309 Ill. App.3d 686, 693, 722 N.E. 2d 1206 (4th Dist. 2000). Christy-Foltz, a subcontractor, agreed to indemnify the owner and general contractor against "any and all claims, suits, losses, and expenses" arising from its negligence. The general contractor brought an indemnity and contribution action against Christy-Folz for its liability for a Christy-Folz employee's injuries. The trial court determined that Christy-Foltz, through its indemnity agreement, did, in fact, waive the *Kotecki* cap. Christy-Foltz sought coverage for the liability beyond the *Kotecki* cap under its employer's liability policy. Standard in employer's liability policies, however, the policy contained an exclusion for any liability voluntarily assumed by the employer. (Unlike a CGL policy, the employer's liability policy does not contain an exception to the exclusion which allows coverage for an insured contract.) The court held that the exclusion for voluntarily assumed liability encompassed *Braye* waivers because they are voluntary assumptions of liability. Therefore, the employer's liability policy did not cover liability assumed via a *Braye* waiver.

Significantly, the *Christy-Foltz* court did not reach the issue of whether the *Braye* liability was covered by a CGL policy. Courts have yet to address whether a CGL policy would cover this type of liability. The argument should be made that if the action is excluded in the employer's liability policy as "liability assumed under contract," then it is covered under the "insured contract" definition.

Are Liability Defenses Confused with Coverage Defenses?

How are liability defenses confused with coverage defenses? A recent example of this danger comes from the Fifth Appellate District of Illinois. In *Hankins v. Pekin Ins. Co.*, 305 Ill. App. 3d 1088, 713 N.E.2d 1244 (5th dist. 1999), a trucking company ("Trucker") contracted with a trucking terminal ("Owner") to provide loading and unloading services. As part of its agreement, Owner agreed to indemnify Trucker. One of Owner's employees was injured while unloading one of Trucker's trucks, when the truck pulled away from the loading dock causing his fork lift to fall to the ground. The employee sued Trucker. Trucker sued Owner in contribution and for indemnity.

Owner was insured under a 1986 edition ISO form CGL policy issued by Pekin. Owner tendered the defense of the third-party complaint to Pekin. The parties lined up as follows:

Ervin, employee of Hankins (Terminal Owner)
(INJURED PLAINTIFF)
(SUES)
Rudolf (Trucker)
(DEFENDANT/INDEMNITEE/ENTITY WITH
"TORT LIABILITY")
(SUES)
Hankins (Owner)
THIRD PARTY DEFENDANT
(INSURED of Pekin/INDEMNITOR)
PARTY WHO ASSUMED TORT LIABILITY OF
INDEMNITEE

Pekin accepted the defense of the contribution action, but not the defense of the counts for indemnification and breach of contract. The case between Trucker and Owner's employee was subsequently settled for \$100,000.

The indemnification clause read:

(a) Hold Harmless. [Insured] agrees to indemnify and hold harmless [Carrier] from and against all claims, damages, losses, and expenses, including reasonable attorney's fees which might arise out of the performance of any work to be performed hereunder by [Insured], including all damages for bodily injury, illness, death, property damage and cargo loss, caused in whole or

in part by [Insured's] negligent act or omission [or] noncompliance with any part of this contract or that of anyone employed by [Insured] or for whose acts [Insured] may be liable.

The trial court found that the policy provided coverage and that Pekin had a duty to defend Owner in the third party suit brought by Trucker. It suggested that “because the complaint alleged that the negligence of Owner was at least in part the cause of Ervin’s injuries, Owner could potentially be liable for all of Trucker’s damages, including those due to Trucker’s own negligence.” Therefore, the trial court reasoned, the contract between Owner and Trucker was an insured contract.

The appellate court disagreed. It determined that the provision in the Owner-Trucker agreement did not create an insured contract. As such, Pekin did not have a duty to defend Owner on the indemnification count.

The court reasoned that the language in the agreement did not express any intention for the Owner to indemnify the Trucker against the Trucker’s own negligence. In fact, the language of the provision expressed the contrary. The court defined “insured contract” as requiring the insured to indemnify another for the other’s negligence. Because the hold harmless agreement did not obligate the insured to indemnify the Trucker for the Trucker’s own negligence, it did not constitute an “insured contract” and did not trigger the exception to the exclusion.

In its analysis, the court made two significant mistakes. First, it ignored the policy definition of “tort liability.” It limited the concept of “tort liability” to “negligence.” If the court had looked at the policy definition, it would have discovered that the policy defined “tort liability” more broadly. Under the policy definition, “tort liability” encompasses any “liability that would be imposed by law in the absence of any contract or agreement.” The indemnification agreement applies to any liability that Trucker faces because of Owner’s actions.

The liability of an indemnitee, as defined by the policy, is clearly broader than “negligence.” “Negligence” is defined as conduct which is performed without conforming to a standard of care. But an indemnitee may be vicariously liable for the conduct of another, without being negligent itself. Any party that is in charge of certain work becomes responsible for non-delegable duties, without being negligent. For example, see *Great American Ins. Co. v. West Bend Mutual Ins. Co.*, 723

N.E.2d 1174 (Ill. App. 2000) (Insured liable under Structural Work Act even though another party’s conduct caused the injury).

However, the court also made a mistake that careful reading of a policy would not prevent: it looked to the indemnity agreement to determine coverage issues. It held that the indemnity agreement did not require Owner to indemnify Trucker because Trucker’s liability arose out of its own negligence. Therefore, the court reasoned, because the indemnification agreement was not enforceable, the insurer need not provide coverage to the insured. Because the facts did not justify holding the Insured liable for indemnity, the court let the Insurer off the hook. Whereas, the insurer should have acknowledged a duty to defend its insured and then raised the unenforceability of the indemnity agreement as a defense against liability, it abandoned the insured.

In *Allianz Insurance Co. v. Goldcoast Partners, Inc.*, 684 So. 2d 336 (Fla. Ct. App. 1996), the court obviously confused coverage with liability in an action for indemnity. The insured chair manufacturer agreed to indemnify Burger King from damages unless caused by Burger King’s own negligence. In evaluating whether the manufacturer’s CGL policy provided coverage for the manufacturer against Burger King’s claims, the court incorrectly framed the issue. The court held that the indemnity agreement was insufficient to require the manufacturer to indemnify Burger King for Burger King’s own negligence. Therefore, it concluded there was no coverage provided under the policy for an insured contract. *Allianz*, 684 So.2d at 337.

Another court confused the issue of whether there was a duty to defend with the question of liability in *Homan Erection Co. v. Employers Insurance of Wausau*, 920 P.2d 1125 (Ore. Ct. App. 1996).

A Homan employee was injured. The employee sued the general contractor, and the general contractor sued the sub for contractual indemnity. The subcontractor sought coverage from its CGL insurer. The court held the subcontractor was not covered because the worker’s compensation exclusivity provisions prevented the subcontractor from being held liable.

These cases show that courts can inappropriately deprive insureds of the protection provided by the contractual liability coverage. If the court focuses on the liability issue, rather than the coverage issue, the insured loses the valuable protection of a defense. Courts

and insurers must recognize that the insurer should provide the insured a defense for claims of indemnity, not a denial of coverage for questionable liability matters.

Does Indemnity Coverage Trump the Employee Exclusion?

One of the most common situations requiring indemnity arises when the indemnitor's employee is injured or killed. Worker's compensation statutes mandate that the exclusive remedy against the employer is worker's compensation. The employee will, therefore, seek recovery against other parties with whom the employer has contractual relationships. In these contracts, the employer (indemnitor) may have promised to indemnify and hold harmless the other party (indemnitee).

Clearly, the indemnitee expects that the indemnitor will have insurance coverage for the promise to indemnify if the indemnitor's own employee is injured or killed. Typically, the contract requiring indemnity specifies that the indemnitor must procure contractual liability coverage. Does the CGL policy give the indemnitor such coverage? The answer is yes, but only if the employee exclusion in the general liability policy contains an "insured contract" exception.

If the employer is the target in a third-party suit, either for contribution, subrogation or indemnity, typically the employee exclusion will apply. Courts have construed the employee exclusion in the CGL policy to apply to third-party actions. *Aetna Casualty & Surety Co. v. Beautiful Signs, Inc.*, 146 Ill. App. 3d 434, 496 N.E.2d 1229 (3rd Dist. 1986); *Reliance Insurance Company v. Nick J Giannini, Inc.*, 158 Ill. App. 3d 657, 511 N.E.2d 755 (1st Dist. 1987) (no coverage for employer named a third-party defendant because the action is for bodily injury to an employee).

The expected result was obtained in *Travelers Indemnity Co. v. LLJV Devel. Corp.*, 227 A. D. 2d 151, 643 N.Y.S. 2d 520 (N.Y.A.D. 1st Dept. 1996). A construction manager and its worker's compensation/employer's liability insurer sued the general contractor and its liability insurer. They sought recovery for a settlement paid to the manager's employee for injuries he suffered on the work site. The court held that the injuries suffered by the employee came within the coverage protected by the "incidental contract" exception to the employee exclusion in the general contractor's CGL policy.

One should not take for granted that an "insured contract" exception to the employee exclusion is in all CGL policies. The policy's exclusion for "bodily injury to any employee of the named insured" applied to an additional insured because the "insured contract" exception was not included in the employee exclusion. *Consolidated Edison Co. of N Y, Inc. v. United Coastal Insurance Co.*, 216 A. D. 2d 137, 628 N.Y.S. 2d 637 (1st Dept. 1995).

The "insured contract" exception to the employee exclusion is crucial to the analysis of coverage in the *Braye v. Archer-Daniels-Midland* scenario discussed above. The basic third-party claim against the employer arises from the Illinois Contribution Act. The employee exclusion is clearly applicable to the Contribution Act. The employer must look to its worker's compensation/employer's liability insurer for defense and coverage. Where the third-party plaintiff asserts that the employer has agreed to be liable beyond its worker's compensation exposure, this "liability assumed under contract" resurrects an indemnity cause of action. If the CGL policy did not contain the "insured contract" exception to the employee exclusion, the CGL policy would not apply.

Practical Advice: Meeting the Drafting Challenge

The *Hankins v. Pekin* case is a great example of how the courts are easily lead astray by over-zealous insurers. Pekin denied it owed its insured a duty to defend when its insured was sued on an indemnity agreement. Clearly, the indemnity agreement in that case was not well-crafted, but it should not have prevented the "insured contract" coverage from applying.

This mistake is particularly problematic in states with anti-indemnification statutes which do not allow for contracting parties to provide indemnification for the indemnitee's own negligence. The practical result of this holding is to destroy indemnification in these states. Fortunately, some changes in drafting may help prevent future judicial mistakes. Including the language of the CGL policy in the indemnification agreement may help eliminate these mistakes by forcing the court to apply the correct definitions in its analysis.

For instance, take the operative words in the Hankins Agreement.

(a) Hold Harmless. [Hankins] agrees to indemnify and hold harmless [Rudolf] from and against all claims, damages, losses[,] and expenses, including reasonable attorney's fees which might arise out of the performance of any work to be performed hereunder by Hankins, including all damages for bodily injury, illness, death, property damage[,] and cargo loss, for the liability of Rudolf caused in whole or in part by Hankin's negligent act or omission [or] non[]compliance with any part of this contract or that of anyone employed by Hankins or for whose acts Hankins may be liable.

If the definition of "tort liability" from the policy were inserted into the clause it would read:

(a) Hold Harmless. [Hankins] agrees to indemnify and hold harmless [Rudolf] from and against all claims, damages, losses[,] and expenses, including reasonable attorney's fees which might arise out of the performance of any work to be performed hereunder by Hankins, including all damages for bodily injury, illness, death, property damage[,] and cargo loss, for the liability of Rudolf ***that would be imposed by law in the absence of any contract or agreement*** caused in whole or in part by Hankin's negligent act or omission [or] non[]compliance with any part of this contract or that of anyone employed by Hankins or for whose acts Hankins may be liable.

Conclusion

Contractual liability coverage is part of every basic CGL policy. The coverage provides valuable protection to the insured for an important part of normal business agreements—the contractual assumption of liability. Nearly every contract contains indemnity as a risk-shifting mechanism. The insurance protection for that promise is provided, as long as the insured knows how to access it. Potential liability, even arising from a contract, should be examined with contractual liability coverage in mind.

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Endnotes

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