Contractual Liability and the CGL Policy

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What is meant by contractual liability and how it actually works is not always well understood. In this new column, Craig Stanovich helps clear up the misconceptions.

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Contractual liability is a very important concept in the world of risk management and insurance. Yet, what is meant by contractual liability and how it actually works is not always well understood. This article is intended to clarify the concept of contractual liability with examples of risk transfer by contract as well as providing an explanation, with illustrations, as to how the contractual liability insurance, found in the commercial general liability (CGL) insurance policy, applies.

In General

Outside the context of insurance, contractual liability (or liability because of a contract) has a very broad meaning—a promise that may be enforced by a court. Consider the following simple example. I agree to paint your house for $1,000 and collect $500 prior to the job. After I accept the $500, I obtain a more lucrative offer and never show up to paint your house. You can go to court and claim the $500 you paid me, as I have breached the contract. Your claim is a contractual liability claim.

Agreement To Assume Liability

It is common for businesses or organizations to agree, usually in writing, to take on the liability of someone else—liability they would not otherwise have. This form of agreement, where one party takes on or assumes the liability of another by contract, is commonly called a "hold harmless" or "indemnity" agreement.

Hold Harmless or Indemnity Agreement. In an indemnity or hold harmless agreement, one party (the indemnitor) promises to reimburse, and in some cases defend, the other party (the indemnitee) against claims or suits brought against the indemnitee *by a third party*. The purpose of the hold harmless or indemnity agreement is to transfer the risk of financial loss from one party (the indemnitee) to another party (the indemnitor). This transfer or shifting of financial consequences is often called non-insurance contractual risk transfer and is considered a risk financing technique.

Properly written hold harmless and indemnity agreements override common law and afford an indemnitee the right to collect from the indemnitor, in some cases even if liability arises out of the indemnitee's *sole negligence*. While each state has its own statutes and case law that may restrict what may or may not be transferred, it is a mistake to conclude that *all* hold harmless and indemnity agreement are void and against public policy simply because the agreement assumes liability for the sole negligence of another.

One very important aspect of the hold harmless or indemnity agreement is that it does *not* relieve the indemnitee (the party with the benefit of the promise) from liability to the third party. The indemnitee may be found to be completely liable to the third party for its bodily injury or property damage.

The hold harmless gives the indemnitee a legal right to collect from the indemnitor (to the extent included in the contract and allowed by law) for the damages paid to the third party. The purpose of contractual liability insurance is to pay, on behalf of the indemnitor, the damages to the third party.

Where To Find Hold Harmless and Indemnity Agreements. Businesses or organizations enter into in a wide variety of contracts in which hold harmless or indemnity agreements may be found. One very common contract, in which a hold harmless or indemnity agreement is almost always found, is a real estate lease agreement between tenant and landlord. A sample hold harmless and indemnity clause found in a real estate lease is:

The Lessee will save the Lessor harmless and keep it exonerated from all loss, damage, liability or expense occasioned or claimed by reasons of acts or neglects of the Lessee or his employees or visitors or of independent contractors engaged or paid by Lessee whether in the leased premises or elsewhere in the building or its approaches, unless proximately caused by the negligent acts of the Lessor.

As many indemnity or hold harmless clauses may be quite lengthy and difficult to read, it is often a challenge for risk managers to determine with any precision the scope of liability that has been assumed. The following example may prove helpful to explain how the above agreement might work.

An Illustration of the Workings of a Hold Harmless or Indemnity Agreement. A tenant (Lessee) in a multi-tenanted professional office building hires an electrician (an independent contractor) to rewire a portion of the tenant's (Lessee's) office. About a year after the rewiring is finished, another tenant receives a severe electrical shock when plugging in an appliance, resulting in serious injuries to the tenant.

The injured tenant brings suit against the landlord (Lessor) demanding compensation for her injuries, alleging that the landlord breached its duty to properly wire the building. The investigation strongly suggests that the injury of the tenant was caused, at least in part, by the electrician's wiring job. Nonetheless, the landlord (Lessor) is found to have responsibility for the injuries and is ordered to pay the injured tenant $150,000 in compensatory damages.

As the tenant (the Lessee) has agreed to indemnify the landlord (Lessor) for the acts of the tenant's (Lessee's) independent contractors, the tenant (Lessee) is obligated by the lease's hold harmless clause to pay the $150,000, either as payment to the landlord or directly to the injured tenant. In this situation, the tenant (Lessee) would not normally have had any liability to the injured tenant. His liability arises solely from the agreement, as part of the lease, to take on the liability of the landlord. The tenant's contractual liability insurance would pay on his behalf the $150,000 damages owed.

While the electrician may ultimately have to pay $150,000 (or a lesser amount) via a subrogation action, the landlord (Lessor) does *not* have to wait for the result of further litigation or be concerned with proving fault on the electrician's behalf in order to recover the $150,000 (the tenant assumed liability for *the acts* of his independent contractors, regardless of negligence). Even if the Landlord could prove fault on the electrician's behalf, it may only be partial fault, and may result in the landlord collecting less than the $150,000 in damages.

In short, the landlord has transferred the financial risk of having tenants in his or her building back to each tenant via the hold harmless and indemnity agreement inserted in the lease.

Contractual Liability Insurance and the Commercial General Liability Policy

Contractual liability insurance has been automatically provided within the commercial general liability (CGL) policy since 1986. The mechanics of how coverage is actually provided does merit some explanation.

The first mention of "Contractual Liability" in the 2001 CGL policy is as the title of an exclusion. Coverage is eliminated by this exclusion for assumption of liability in a contract or agreement. There are, however, two important exceptions:

- Liability of the insured that would be imposed without the contract or agreement

  or

- Liability assumed in a contract or agreement that is an "insured contract."

The term "insured contract" is defined later in the policy and is critical to understanding the coverage provided. More on "insured contract" later.

Breach of Contract Claims

On occasion, a policyholder will seek coverage under the CGL policy for a breach of contract claim. In other words, the damages being demanded do not arise from liability assumed in a hold harmless or indemnity agreement, but are due to failure to meet an agreed upon obligation. Avoiding coverage for breach of contract claims is the very reason the CGL first excludes all contractual coverage, then grants limited contractual liability coverage by an exception to the exclusion. Here is an example of what is intended to be excluded:

A contractor agrees in a construction contract to insure a building that is being built for the owner. Unfortunately, the contractor forgets to place the insurance on the building, which a tornado destroys shortly before its completion. The owner seeks payment from the contractor for the value of the building, asserting a breach of contract action for failing to purchase insurance. The contractor then makes claim under the contractual liability coverage of his CGL policy for the value of the building.

Assumption of Liability by Contract or Agreement

What is actually meant by "liability assumed by contract" has been the topic of a considerable amount of litigation, with varied outcomes. An Alaska case—*Olympic, Inc. v Providence Washington Insurance Co.*, 648 P2d 1008 (Alaska 1982), as quoted in *Gibbs M. Smith v United States Fidelity & Guaranty Co.*, 949 P2d 337 (Utah 1997)—provides this explanation, which reinforces the concept that coverage is not for breach of contract:

Liability assumed by the insured under contract refers to liability incurred when one promises to indemnify or hold harmless another, and does not refer to liability that results from breach of contract.

The court went on to explain the differences in the nature of the obligations:

Liability ordinarily occurs only after breach of contract. However, in the case of indemnification or hold harmless agreements, assumption of another's liability constitutes performance of the contract.

Assuming a Duty versus Assuming a Liability

Assuming the *liability* of another (agreeing to be responsible for some else's legal obligation to pay damages to third parties) is sometimes confused with assuming a *duty* to others (an obligation to act or not to act that would not exist but for an agreement). For example, I may enter into a maintenance contract whereby I agree to regularly service the machinery on your premises, creating a duty that I would not otherwise have had. But I carelessly fail to service a machine that later malfunctions, injuring your employee. It is subsequently found that my failure to service the machine caused the malfunction and employee's injury. The employee brings suit against me for her injuries.

Some insurers have mistakenly denied CGL claims such as these, contending the claim is a breach of contract claim and thus excluded by the contractual liability exclusion of the CGL. A more careful analysis of this type of claim will reveal that it is in actuality a tort-based claim—specifically negligence. I breached a duty (to maintain the machinery), such breach being the proximate cause of the injury to the employee. The *duty* was assumed or created by the contract; no assumption of liability via a hold harmless or indemnity agreement was involved. The damages claimed were not by the other party to the contract and were not the cost to fulfill the contract, but rather damages resulting from injuries to an unrelated party, the injured employee.

This issue was addressed in *Olympic*, in which the Alaskan court held that:

Legally obligated to pay as damages … refers to liability imposed by law for torts and not to damages for breach of contract … the only exception to this general rule arises when the *contract breach itself results in injury to persons or property.* (Emphasis added.)

Coverage by Exception—The "Insured Contract"

The exception to the contractual liability exclusion does provide broad contractual liability coverage for liability assumed in a contract as long as:

1. The bodily injury or property damage occurs after entering into the contract, and
2. The liability is assumed in a hold harmless or indemnity agreement that falls within the definition of "insured contract."

The contractual liability coverage provided for "insured contracts" is "blanket" in that the insured does not need to list or designate the covered contracts (as was required under the 1973 Contractual Liability Coverage Part), nor is a separate premium charge made for contractual liability coverage. Contractual liability coverage in the CGL is also "broad form," as it applies even if an insured assumes liability for the sole negligence of the indemnitee.

"Insured contract" is defined, and the definition begins by listing five types of contracts that are common to many businesses and organizations:

- Lease of premises (but not for a promise to pay fire damage to a premises you rent or occupy)
- Sidetrack agreement
- Easement or license agreement (not for construction or demolition on or within 50 feet of a railroad)
- Indemnify a municipality (except for work for the municipality)
- Elevator maintenance agreement

Coverage for the above five contracts was automatically included in the 1973 CGL policy (and prior editions) as "incidental contracts." When the CGL was overhauled and simplified in 1986, the listing of these "incidental contracts" remained to clarify that coverage was still intended to apply to liability assumed in these contracts.

The "blanket" contractual clause extends coverage to any contract pertaining to the named insured's business under which they assume the *tort* liability of another. Tort liability means liability imposed *other than by contract.* Put another way, coverage applies only to a particular type of assumed liability—that which arises from a breach of duty and that exists independent of any contractual relationship the indemnitee may have with the injured party. [Barry R. Ostranger and Thomas R. Newman, *Handbook on Insurance Coverage Disputes* 7.01 (8th Ed. 1995).]

What Is Not an "Insured Contract"

"Insured contract" does not include an agreement to indemnify:

- A railroad for construction or demolition operations within 50 feet of railroad property and affecting any railroad bridge or trestle, tracks, roadbeds, tunnel, underpass or crossing.
- An architect, engineer or surveyor for their professional services.
- Others for professional services if assumed by an insured who is an architect, engineer or surveyor.

Railroad protective liability and professional liability coverage is needed if an insured has exposures falling within the exclusions.

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