In Defense of Insured Contracts

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The term "insured contract" certainly sounds reassuring. As the definition of "insured contract" lists not only certain contracts or agreements (contract for the lease of premises, sidetrack agreement, easement or license agreement, obligations to municipalities except to work for them, elevator maintenance agreement), it includes "that part of any other contract or agreement pertaining to your business..."

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Without delving into the thrilling world of contracts a bit further, I suppose it is easy to assume that anything found in one of these contracts is insured.

Creating a Small Problem

If a tenant agrees in his lease to include his landlord as an additional insured on the tenant's standard Insurance Services Office, Inc. (ISO), December 2004 edition of the commercial general liability (CGL) policy, surely this contractual obligation to include the landlord as an insured is now covered by the tenant's insurer. In other words, isn't the landlord now an additional insured on the tenant's CGL?

Let's suppose that a liability claim is made naming the landlord but not the tenant. The landlord tenders the claim to the tenant's liability insurer—who refuses the claim faster than you can say, "The cat is eating my cereal again." The insurer has the nerve to suggest that the landlord is not an additional insured—even though the insurer agrees this is a contract for a lease of premises and thus an "insured contract." Are they serious? Well, insurance companies are famous for their practical jokes.

Shortly after the claim is settled by the *landlord's* insurer, the landlord's insurer, via subrogation, brings claim against the tenant for breach of contract—the allegation is that the tenant did not do what they agreed to do in the lease of premises agreement—add the landlord as an additional insured to the tenant's liability policy. The tenant hands this claim over to his insurer with the same result: his insurer refuses to defend or pay this claim. What gives here? This is all great fun until someone whacks their head (or in the adult world, loses money). Must we stoop to reading the CGL and try to figure out what "insured contract" means? It seems we must.

Contractual Liability Exclusion

The proper context, of course, for the term "insured contract" is the Contractual Liability exclusion (exclusion b.) of the CGL. In short, this exclusion to Coverage A—Bodily Injury or Property Damage, eliminates coverage for "'bodily injury' or `property damage' for which an insured is obligated to pay damages by reason of assumption of liability in a contract or agreement."

Assumption of Liability

The operative phrase in this exclusion is "assumption of liability by contract." The general meaning attributed to "assumption of liability" is the insured has agreed to be responsible for *another person's or organization's* liability to a *third party* who suffers injury or damage. The clause or portion of the contract in which an insured assumes the liability of others is known as a hold harmless or indemnity agreement.

A clear explanation of what is meant by "liability assumed by contract" is found in the case *Olympic, Inc. v. Providence Wash. Ins. Co.*, 648 P.2d 1008 (Alaska 1982):

> "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.... 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.

It is important to grasp this concept to understand "insured contract," as the contractual liability exclusion goes on to state that the exclusion does not apply to liability assumed in an "insured contract," thus providing coverage by this exception to the contractual liability exclusion. Put another way, insurance coverage for an "insured contract" is solely concerned with an insured's obligation to hold harmless or indemnify another. As noted in *Olympia*, liability assumed in a contract has nothing to do with the insured's failure to perform the contract (breach of contract)—such as the promise of the tenant to add the landlord as an additional insured."

Contractual Liability Insurance

In essence, contractual liability insurance coverage provided by the CGL applies only to those hold harmless or indemnity agreements found in an "insured contract." If an insured agrees to indemnify another for bodily injury or property damage, and that indemnity agreement is part of an "insured contract," then in most situations, the contractual liability insurance of the CGL will pay what the insured must pay because of the indemnity agreement. (For more on contractual liability insurance, see Contractual Liability Insurance and the CGL Policy, May 2002.) Conversely, if an indemnity agreement is not part of an "insured contract," the insured's CGL will not respond to the insured's obligations (although the insured is still required to indemnify the other person).

Hold Harmless and Indemnity Agreements

As "insured contracts" are about hold harmless and indemnity agreements, definitions of these terms are essential:

Hold Harmless Agreement—A contract in which one party agrees to indemnify the other. See Indemnity. [*Black's Law Dictionary*, Eighth Edition]

Indemnity Clause—A contractual provision in which one party agrees to answer for any specified or unspecified liability or harm that the other party might incur. Also termed hold harmless clause. [*Black's Law Dictionary*, Eighth Edition]

Possibly the easiest way to explain an indemnity agreement is to focus on the idea of answering for the liability of another. The parties to a hold harmless or indemnity agreement are commonly referred to as *indemnitor* (the person or organization that will be indemnifying another) and the *indemnitee* (the person or organization receiving the benefit of the indemnity).

Indemnity is Not Insurance

An agreement to indemnify another is not insurance and has nothing to do with insurance. It is difficult to overemphasize this point. While insurance may pay for obligations assumed in an indemnity agreement, insurance is completely independent of the obligation to indemnify. The indemnity agreement is found in a contract or agreement (one that the insured hopes is an "insured contract"), that is completely outside of and therefore extrinsic to an insured's CGL insurance policy.

Going back to our example of landlord and tenant, what should now be plain is that the contractual obligation to add a person or organization as an additional insured is not accomplished if that insurance obligation happens to also be within an "insured contract. The mistake in our example is caused by confusing automatic (blanket) additional insured coverage with liability assumed in an "insured contract."

The Supreme Court of Rhode Island succinctly distinguishes between indemnity and the obligation to obtain insurance in *A.F. Lusi Constr., Inc. v. Peerless Ins. Co.* (2002)

> "Lusi first suggests that the indemnification provision in its subcontract with Pasquazzi, § 11.11.1, shows that Pasquazzi agreed to obtain insurance for the benefit of Lusi. The terms of the indemnification provision, however, are conspicuously silent with respect to any obligation on Pasquazzi's part to provide insurance for Lusi. *A contractual duty to "indemnify and hold harmless" is not the legal equivalent of a duty to procure insurance coverage for that indemnity obligation.* Thus, § 11.11.1 of the subcontract neither required Pasquazzi to obtain insurance for Lusi, nor did it provide support for Lusi's contention that it was an additional insured under the Peerless policy." [Emphasis supplied.]

Well-written contracts that contain indemnity agreements, such as the standard AIA or AGC construction contracts, do not confuse insurance obligations with indemnity clauses and have separate and distinct clauses (including titles) for each. Unfortunately, it is not uncommon to see indemnity agreements buried within portions of the insurance requirements section of the contract, significantly contributing to the confusion of indemnity and insurance.

Status of Indemnitee

As indemnity clauses are not insurance, it follows that indemnitees are not insureds. While an indemnitee may benefit from the indemnitor's CGL policy, the indemnitee is not a party to the indemnitor's insurance policy. Insureds, including additional insureds, are parties to the insurance contract (to the extent the insured is afforded coverage) and have all rights afforded to that type of insured.

Usually included is the right to tender a claim directly to the insurer of the CGL on whose policy they are an additional insured, the right to demand the insurer fulfill the defense obligation provided to the additional insured, and right to sue the insurer for breach of contract should the insurer not provide the coverage (including defense) afforded by the additional insured endorsement to the additional insured.

Insurer's Obligation to Defend Indemnitee

While indemnitees do not have rights under the policy of the indemnitor that are the equivalent of an insured, that does not mean that the indemnitor's insurer *never* has any obligations to the indemnitee.

The Supplementary Payments section of the CGL does obligate the insurer to provide a defense to the indemnitee, but only under very limited circumstances. Although not first in the list of numerous conditions that must be met to obligate the indemnitor's (insured's) insurer to defend the indemnitee, the obligation to defend an indemnitee really starts with the wording in the indemnity agreement.

Reimbursement of Attorney Fees versus Obligation to Defend Indemnitee

Indemnity agreements are often written with wording similar to the illustration below:

> … tenant agrees to hold harmless and indemnify landlord for any loss, costs or expenses, including attorney fees and costs, attributable to bodily injury or damage to property, arising out of tenant's use of the demised premises and common areas, even if the indemnified party is partly at fault for such bodily injury or property damage ...

In the above indemnity agreement, the tenant (indemnitor) has agreed only to indemnify (reimburse) the landlord (indemnitee) for attorney fees. The wording of this indemnity agreement does not obligate the indemnitor to defend the indemnitee. Contrast the above to the wording below, which simply inserts the word "defend:"

> … tenant agrees to hold harmless, *defend* and indemnify landlord for any loss, costs or expenses, including attorney fees and costs, attributable to bodily injury or damage to property, arising out of tenant's use of the demised premises and common areas, even if the indemnified party is partly at fault for such bodily injury or property damage … [Emphasis added.]

In this wording, the tenant (indemnitor) has agreed to not only hold harmless and indemnify the landlord (indemnitee), but has also agreed to defend the indemnitee. This can make a significant difference, as some courts that have statutory restrictions on indemnification agreements have still required the indemnitor to defend the indemnitee until the fault of the parties is established as a matter of law. In other words, including the duty to defend in the indemnity clause may greatly broaden the obligation of the indemnitor.

In sum, one of the first considerations as to whether the indemnitor's insurer is obligated to defend the indemnitee is whether the indemnitor has agreed in the indemnity clause (which must be part of an "insured contract") to defend the indemnitee. If the indemnitor has agreed to *reimburse* the indemnitee for attorney fees as opposed to agreeing to *defend* the indemnitee, the indemnitor's insurer is not obligated to defend the indemnitee.

However, in the former circumstance (reimbursement), the indemnitor's insurer will likely be obligated to the indemnitor to pay for reimbursement of the indemnitee's attorney fees, but this obligation is to the indemnitor, not the indemnitee.

Other Conditions

In addition to agreeing to defend the indemnitee in an "insured contract," the following conditions must be met for the indemnitor's insurer to be required to provide a direct defense to the indemnitee.

Both Named in Same Suit. The indemnitee and indemnitor (insured) must both be named in the same suit. It is certainly very possible that only the indemnitor will be named in the suit, in which case the indemnitor's insurer has no duty to defend the indemnitee.

For example, in a construction project, subcontractor A agrees to hold harmless, defend, and indemnify general contractor B. An employee of subcontractor A is injured at the jobsite and brings a tort claim against general contractor B, alleging the failure of general contractor B to maintain a safe work site. General contractor B seeks defense and indemnification from subcontractor A under the indemnity agreement.

As the employee of subcontractor A did not name subcontractor A in the suit (and would likely be prevented from doing so as exclusive remedy applies as between employee and subcontractor A), subcontractor A's insurer would not be obligated to defend general contractor B (although subcontractor A is still obligated to defend general contractor B), as both A and B are not named in the same suit.

No Conflict. The allegations in the suit as well as what the indemnitor's insurer knows about the suit (in addition to the allegations) must be such that no conflict of interest, in the judgment of the insurer, appears to exist between the indemnitor (insured) and indemnitee.

For example, if there is a dispute of fact as to who did what to whom—the indemnitor or indemnitee—the insurer may well deem this a conflict of interest and refuse to defend the indemnitee as the "no conflict of interest" condition has not been met. This is a particularly bothersome condition as finding the appearance of a conflict is at the discretion of the insurer.

A conflict would likely not exist if both the indemnitor (insured) and the indemnitee agreed to the facts and both strongly believed no liability existed for the indemnitee.

Request To Defend. The indemnitor (insured) and indemnitee must both request the indemnitor's insurer to conduct and control the defense and both the indemnitor and indemnitee agree that the *same legal counsel* can handle the defense. This condition is sometimes difficult to meet as it is not uncommon for indemnity agreements that require defense of the indemnitee to state the indemnitee will use legal counsel of its choosing. Exercising this right by the indemnitee would relieve the indemnitor's insurer of the obligation to provide a defense to the indemnitee.

Duty To Cooperate and Authorization. The indemnitor's (insured's) insurer imposes obligations on the indemnitee similar to those imposed on an insured. For example, the indemnitee has a duty to cooperate in the investigation, settlement, and defense; to immediately send the indemnitor's insurer copies of legal papers (demands, notices, summons, etc.); to notify the insurer if any other coverage is available to the indemnitee; to cooperate in coordinating other applicable insurance available to the indemnitee; and to authorize the indemnitor's insurer to obtain written records and information related to the suit to conduct and control the defense.

The duty to provide information regarding other insurance available to the indemnitee may also be troublesome, as one of the prime goals of an indemnity agreement is to transfer the financial consequences of the damages from the indemnitor to the indemnitee. If the indemnitor's insurer attempts to require, for example, that the indemnitee first use the insurance on which the indemnitee is a named insured, the indemnitee is likely to refuse. Such a refusal may relieve the indemnitor's insurer of the obligation to defend.

Continuing Duty. All of the above duties must be continuously met by the indemnitee. The indemnitor's (insured's) insurer's obligation to defend the indemnitee ends at any point where the indemnitee fails to comply with the above conditions. The indemnitor's insurer's duty to defend the indemnitee also ends when the policy limits have been exhausted by payment of settlement or judgment.

Costs In Addition to or Included within the Limit

A controversy erupted in the early 1990s when ISO stated that it was never their intent to defend an indemnitee. After much discussion, ISO eventually changed the CGL policy first by endorsement and later by inserting into the CGL policy form itself the above conditions.

The compromise was the insurer would pay for the cost of defending an indemnitee, either as damages and therefore within the limit or for the cost of directly defending the indemnitee as Supplementary Payments (with such costs being paid in addition to the limit).

In Addition to the Limit. If the indemnitee does fully comply with all of the above conditions and therefore the insurer is obligated to defend the indemnitee, then all costs incurred by the insurer for defense of the indemnitee are considered Supplementary Payments and are therefore paid in addition to the indemnitor's policy limits.

Included within the Limit. As mentioned above, in most cases, to the extent the indemnitor has agreed to reimburse the indemnitee's attorney fees, the indemnitor's insurer will pay the reasonable attorney fees and necessary litigation costs, but such costs are considered *damages* and such payments will reduce the limits of liability available to the indemnitor. Even in those cases where the indemnitor (insured) has agreed to defend the indemnitee, but the conditions noted above are not met, the indemnitor's (insured's) insurer will likely pay on behalf of their insured the reasonable attorney fees and necessary litigation costs incurred by the indemnitee, but such costs will also be considered damages and payment of such expenses will reduce the policy limits available to the indemnitor (insured).

Additional Insured versus Indemnity

It is very common to not only agree to indemnify another, but also agree to add that indemnitee as an additional insured to the indemnitor's CGL policy. While the indemnitee cannot collect twice for the same damages, this "belt and suspenders" approach is employed to make certain that the additional insured/indemnitee has the benefit of both the insurance of the indemnitor as an additional insured and benefit of the indemnity agreement.

Particularly in the event of a serious claim, it is important to keep in mind that the indemnitee will likely pursue, at the same time, both indemnification via the indemnity agreement as well as defense and payment of damages as an additional insured. As the facts emerge regarding the claim, it may be turn out that the indemnity agreement is unenforceable or that the additional insured endorsement protecting the indemnitee is not broad enough to cover the indemnitee as an additional insured. Or that the insurance limits provided to the additional insured are not adequate to protect the indemnitee against the entire claim. In the latter circumstance, it is critical to keep in mind that the obligation to indemnify another is *usually without limit*—the indemnitor may be obligated to indemnify another in excess of the insurance provided to the indemnitee as an additional insured.

Conclusion

Knowing the meaning of "insured contract" and how the term fits into the CGL policy, as well as having an appreciation for the underlying contracts to which the "insured contract" applies, including obligations found in those contracts to defend others or indemnify for attorney fees and litigation costs, can be critical to providing sound risk and insurance advice.

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