

# **CONTRACTUAL RISK MANAGEMENT:**

## **CONSIDERATIONS WHEN ALLOCATING THIRD PARTY LIABILITY RISK**

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Business contracts allow parties to prospectively apportion third party liability risk which arises from the parties' relationship. Unfortunately, many contracts do not address all the implications involved with the parties' intent to allocate these risks. Sometimes the lack of specific language is because the parties may not have a full appreciation of the third party risks related to the transaction. The shortcoming can also come from not fully appreciating the impact of the language utilized in light of the insurance held by each of the parties. Any combination of these and other scenarios can alter or nullify the parties' liability risk allocation unless all of the risk's subtleties and implications are addressed.

Contractual risk management provides an infinite variety of ways for parties to accurately and effectively define their exposures and rewards in the business arrangement so long as each parties' obligations and risks assumed are understood by all involved with the contract. The following generically describes some of the more common points to consider when utilizing indemnification

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<sup>1</sup> These materials raise a variety of issues involved with contractual risk management and transference of third party liabilities. The discussions are not intended to be exhaustive of every possible scenario which could or might arise in every business contract. Instead, these materials address some of the more common situations faced, and provides general guidance in identifying and addressing the risks involved. These materials are a starting point, and not an endpoint, in determining what language to utilize in a contract. Resolution of that question requires an analysis of the particular facts and risks at issue, the desires of the contracting parties on how to allocate/transfer the risk, the availability of insurance products to cover the risks, and the skill of the contract drafter to memorialize the parties' intent.

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agreements and insurance clauses as part of the risk management planning. These materials also provide some general insight into why these points should be considered and planned for in the agreement. In addition, the following provides some practical insight into how parties may wish to prospectively craft various clauses, as well as how they analyze the issue raised after a loss is realized.

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## GENERAL CLAUSES

**Choice of Law:** Contracts are governed by state law. Therefore, the parties' obligations under a particular contract clause may be different depending on what state law is applied to the contract. For example, a variety of states void certain types of indemnification agreements because of either public policy or statutory considerations. The most common statutory prohibitions against indemnification of an indemnitee's own fault are the Construction Anti-Indemnification Statutes now in place in well over 40 states. 3 Bruner and O'Connor on Construction Law, § 10:77, p. 917 (2002). Specific statutory prohibitions vary from state to state, and therefore the jurisdiction's statute should be consulted if the parties will be engaged in construction activities. The statutes generally either prohibit the indemnitee from assuming the indemnitor's sole negligence, limit the indemnitee's protection to only the amount of fault of the indemnitor, or contain atypical or miscellaneous limitations. *Id.* Minnesota's statute, for example, is uniquely formatted to prohibit a party from

indemnifying another in a construction contract unless the contract also contains a duty to procure coverage to insure the indemnification obligation. Minn. Stat. Ch. 337.

Some jurisdictions may void an indemnification contract for public policy reasons. An ambiguous clause may limit the scope of an indemnification agreement. Also, some courts look to whether, at the time of contracting, there was a great disparity of bargaining power between the parties. See e.g., Cook v. Southern Pacific Trans. Co., 623 P.2d 1125 (Or. App. 1981) (court invalidated an indemnification clause due to great disparity of ability to shoulder the burden in light of the small dollar value at issue in the contract).

In order to avoid potential unintended application of state law, the contract should have a choice of law provision such as the following:

*“This Agreement shall be governed by the law of the state of \_\_\_\_\_.”*

If the contract does not have this type of clause, the parties must determine what law will apply to the indemnification agreement and/or duty to procure insurance. If there is a dispute over what state law is to apply, a detailed and often-times muddled “choice of law” analysis is performed to answer this question.

Historically, many courts applied a “lex loci” territorial approach concept to the case’s facts to determine which state law applied. The “lex loci” was the law of the place where the right was acquired or the liability was incurred which constitutes the claim or the cause of action. Gray v. Blight, 112 F.2d 696 (10th Cir. 1940). See also Huang v. D’Albora, 644 A.2d 1 (D.C. 1994);

Prudence Life Ins. Co. V. Morgan, 213 N.E.2d 900 (Ind. 1966); Naughton v. Nakkier, 691 A.2d 712 (Md. 1997); Whitten v. Whitten, 548 N.W.2d 338 (Neb. 1996).

The modern trend in many jurisdictions is to analyze the contract under the Restatement (Second) of Conflicts of Laws to determine which state law applies. The Restatement provides that courts should apply the “most significant relationship” test to determine what law governs the contract. Restatement (Second) Conflicts of Law § 188. The “most significant relationship” test considers the following:

- (1) The rights and duties of the parties with respect to an issue in the contract are determined by the local law of the state which, with respect to that issue, has the most significant relationship to the transaction and the parties under the principles stated in § 6 of the Restatement.<sup>2</sup>

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<sup>2</sup> Section 6 of the Restatement sets forth general “choice of law principles”:

- (1) A court, subject to constitutional restrictions, will follow a statutory directive of its own state on choice of law.
- (2) When there is no such directive, the factors relevant to the choice of the applicable rule of law include:
  - (a) the needs of the interstate and international systems;
  - (b) the relevant policies of the forum;
  - (c) the relevant policies of other interested states and the relative interests of those states in the determination of the particular issue;
  - (d) the protection of justified expectations;
  - (e) the basic policies underlying the particular field of law;
  - (f) certainty, predictability and uniformity of result; and
  - (g) ease in the determination and application of the law to be applied.

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- (2) In the absence of an effective choice of law by the parties, the contacts to be taken into account in applying the principles of § 6 to determine the law applicable to an issue include:
- (a) the place of contracting;
  - (b) the place of negotiation of the contract;
  - (c) the place of performance;
  - (d) the location of the subject matter of the contract; and
  - (e) the domicile, residence, nationality, place of incorporation and place of business of the parties.

These contracts are to be evaluated according to their relative importance with respect to the particular issue.

- (3) If the place of negotiating the contract and the place of performance are in the same state, the local law of this state will usually be applied, except as otherwise provided in §§ 189-199 and 203.

Restatement (Second) of Conflict of Laws §188. The Restatement also directs that, in insurance contracts, the principal place of the insured's risk is the most important factor. Restatement (Second) Conflict of Laws § 193.

This modern approach is not universal. Some jurisdictions apply other choice of law tests. For example, Minnesota and a few other states, primarily in the Midwest, employ a "choice influencing considerations" methodology to resolve conflict of laws issues. See, e.g., Hime v. State Farm Fire & Cas. Co., 284 N.W.2d 829, 832-33 (Minn. 1979), cert. denied, 444 U.S. 1032, 100 S.Ct. 703, 62 L.Ed.2d 668 (1980); Nodak Mut. Ins. Co. v. Wamsley, 2004 ND 174, 687 N.W.2d 226 (N.D. 2004). If there is a conflict in the application of competing states' laws, and if sufficient contacts exist as to each state to allow application of its law, then five "choice influencing" factors

originally propounded by Professor Robert A. LeFlar in the 1960s are considered to determine which state law applies to interpret the contract:

- the predictability of the result;
- the maintenance of interstate and international order;
- the simplification of the judicial task;
- the advancement of the forum's governmental interest; and
- the application of the "better rule of law."

See, e.g., Milkovich v. Saari, 203 N.W.2d 408 (Minn. 1973).

It is an understatement to say that many times these tests do not provide clear expressions to determine which substantive law applies to the contract. However, it seems the local law of the jurisdiction where the event causing liability occurred will generally apply so long as there is no choice of law clause in the contract and the indemnitor is local, unless there are significant reasons to employ another state's law. Ultimately, this analysis must be done on a case by case basis.

As will be seen below, determining what state law applies could well be the difference between being able to rely on the indemnification agreement and/or the duty to procure insurance to offload the loss, or being forced to retain the exposure arising from the incident.

**Negotiation Clause:** Many business contracts are based on form documents which are developed by one of the parties. While use of standard language encourages uniform application of the law to facts, utilizing "standard" contract language raises a question of whether a court will later determine that the language is ambiguous, and therefore the parties' intent needs to be determined

to enforce the language. See e.g., Transport Indem. Co. v. Dahlen Transport, Inc., 161 N.W.2d 546, 550 (Minn. 1968). If the parties' intent cannot be determined, then the court will likely construe the provision against the drafter. Restatement (Second) of Contracts § 206 (1982); ICC Leasing Corp. v. Midwestern Machinery Co., 257 N.W.2d 551 (Minn. 1977). This is in fact what occurs most of the time as "standard" clauses are never negotiated, and therefore there is no evidence of the parties' intent to construe the language.

The best approach to avoid having a clause construed against the contract's drafter is to include a provision where the parties agree that no provision is to be so construed:

*"The Agreement has been the result of negotiated terms, and therefore the Parties agree neither the Agreement nor portions of the Agreement's language is to be construed against any one party as a drafter."*

**Insurance Policy Disclosure:** Historically, contracting parties have relied on Certificates of Insurance to determine if the other party has in place the insurance contemplated by the business transaction. Unfortunately, this custom has led to innumerable situations where the parties later encounter severe problems because the Certificate did not reflect the actual terms and conditions involved with the referenced policy.

Because of this, both parties are better served by requesting copies of the actual insurance policies contemplated by the transaction to allow them to independently confirm that the coverage intended is actually in existence. In the past, this has been problematic, mostly due to the carriers not actually having a fully assembled copy of the policy which includes the particular additional provisions



mandated by the business transaction. However, this is expected to change as more and more information is maintained electronically.

An example of a clause mandating an exchange of insurance policies is as follows:

*“Each party agrees to provide the other party with a copy of its commercial general or other liability policy or policies referenced in this Agreement, as amended, to allow the parties to confirm that the policy or policies, as amended, provide the coverage contemplated in this agreement.”*

A word of caution is required as to this provision. Just like the business transaction itself, the insurance contracts will also be governed by state law. Specifically, coverage exists if an application of the claim’s facts as applied to the insurance contract in light of the relevant state law results in a finding of coverage. The “relevant state law” is not necessarily the same state’s law which applies to the business transaction. Therefore, the party receiving a copy of the other party’s insurance policy must first ascertain what state law will apply to the policy before she can determine the scope of that coverage as applied to the business transaction’s risk management clauses.

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## INDEMNIFICATION AGREEMENTS

Indemnification agreements contractually obligate one party to indemnify, and many times defend, another against losses arising from the subject matter of the contract. Most jurisdictions interpret the construction and effect of indemnification agreements as a matter of law. See e.g., Art Goebel, Inc., v. North Suburban Agencies, 567 N.W.2d 511, 515 (Minn. 1997). “A party may

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contract to indemnify another for damages or injuries caused by the negligence of the indemnitee and beyond the control of the indemnitor.” Christy v. Menasha Corp., 297 Minn. 334, 211 N.W.2d 773, 777 (1973). Most courts will enforce the scope of an unambiguous indemnification agreement even if it indemnifies the indemnitee for its own negligence unless the agreement runs afoul of public policy or statutory considerations. Therefore, it is important to understand how the state law of the jurisdiction involved will interpret the provision before it is proposed in an agreement.

**Is The Indemnification Agreement Enforceable Under The Applicable State Law?** The concept that one party may agree to assume another’s liability is well accepted in many states’ common law. The question is whether that state, either by caselaw or statute, has placed certain limits or restrictions on the enforceability of the indemnification agreement. There are several legal principles a particular state may consider in determining whether, or to what extent, to enforce the indemnification agreement.

Connection Between the Project and the Liability: Typically, some nexus or connection between the liability and the project is required in order to enforce the indemnification agreement. Minnesota, for example, requires that a temporal and geographic nexus, or a causal nexus, exists between one party’s work and the injuries or damages at issue in order to enforce the agreement. Anstine v. Lake Darling Ranch, 305 Minn. 243, 249, 233 N.W.2d 723, 727 (1975), overruled on other grounds, Farmington Plumbing & Heating Co. v. Fischer Sand and Aggregate, Inc., 281 N.W.2d 838, 840 n. 4 (Minn. 1979). A temporal nexus exists between the party’s work and the injury when a worker’s injury, for example, occurs while the worker is preparing for work, or in the

process of working, but not after the work is complete. Fossum v. Kraus-Anderson Const. Co., 372 N.W.2d 415, 418 (Minn. App. 1985). A geographic connection exists between the injury and the party's work if the injury is sustained on the job site, regardless of its cause. Id. at 417-18. Alternatively, a causal nexus exists when, "but for" the work, the injury would not have occurred. National Hydro Systems v. M. A. Mortenson, 528 N.W.2d 690, 693 (Minn. 1995).

Other states employ a variety of approaches to determine whether the indemnification agreement is enforceable under the circumstances. See e.g., Arthur's Garage, Inc. v. Racal-Chubb Security Systems, Inc., 997 S.W.2d 803, 814 (Tex. Ct. App. 1999)(citing Dresser Indus, Inc. v. Page Petroleum, Inc., 853 S.W.2d 705, 708 (Tex. 1987)) (indemnity provisions are valid and enforceable so long as the agreement meets the "fair notice" requirements of unambiguous terms and conspicuous terms); Burlington Northern Railroad Co. v. Pawnee Motor Serv., Inc., 171 Ill. App. 3d 1043, 525 N.E.2d 910 (Ill. App., 1st Dist. 1988) (indemnity agreements are strictly construed).

Statutory or Other Public Policy Limitations: Indemnification agreements, and especially those which seek to indemnify a party for its own negligence, may be void or unenforceable either because of public policy or statutory considerations. The most common statutory prohibition against indemnification for one's own fault are the Construction Anti-Indemnification Statutes referenced above. Specific statutory prohibitions vary from state to state, and therefore the jurisdiction's statutes should be consulted if the parties' contract addresses construction activities. These statutes generally prohibit one party from assuming another's sole negligence, or limit the party's protection to the amount of fault imposed on the indemnitee, or contain atypical or miscellaneous limitations. Id.

The following are examples of various state's statutes which may impact this analysis. Minnesota's Anti-Indemnification Statute is uniquely formatted to prohibit an indemnitor from indemnifying another in a construction contract unless the indemnitor obtains insurance to cover the obligation. Minn. Stat. Ch. 337. One Arizona statute bars an indemnification obligation if the indemnity sought involves the sole liability of the indemnitee in certain types of claims, but does not enforce this limitation if the indemnitee is merely allowing the contractor access to the land to allow the project to be performed for another. Ariz. Rev. Stat. §§ 32-1159; 34-226; 41-2586. A Texas statute bars a party's indemnification of another for the other's sole or joint negligence unless the injury is to the indemnitor's employees or agents and involves public works projects. Tex. Govt. Code. § 2252.902. One California statute bars enforcement of an agreement which indemnifies another for his or her sole negligence, Cal. Civ. Code. § 2782(a), although this prohibition does not apply to indemnification agreements where the indemnitee allows the indemnitor an accommodation access through the indemnitee's property to perform work for a third party. Cal. Civ. Code. § 2782.1. Illinois has a similar statute barring indemnification of the indemnitee's own negligence when the contract "deal[s] with construction, or for any moving, demolition or excavation;" 740 ILCS 35/1; however, the statute does not necessarily apply to an agreement seeking access through a railroad right-of-way because the right-of way access is not work "dealing with construction, or for any moving, demolition or excavation." Winston Network, Inc. v. Indiana Harbor Belt R. Co., 944 F.2d 1351 (7th Cir. 1991). Often times, a particular state will have several statutory provisions which could impact whether the indemnification provision is enforceable.

Some jurisdictions may void an indemnification agreement because of public policy reasons. Some courts look to whether, at the time of contracting, there was a great disparity of bargaining power between the parties. For example, in Cook v. Southern Pacific Trans. Co., 623 P.2d 1125 (Or. App. 1981), a court invalidated an indemnification clause where the agreement was on a form prepared by the railroad, did not specifically allocate risk of third-party negligence (the cause of the injury to the railroad's employee), and the railroad was under a broad duty of care pursuant to the Federal Employers Liability Act ("FELA"). Despite these "legal" reasons, it appears what motivated the court was the fact the contractor was financially unable to actually perform the indemnification obligation. The contractor was an individual who took on a job to demolish and remove an abandoned station house for the sum of \$1,500.00. Assuming what in effect was the railroad's liability under FELA was just too great of an obligation and reflected too great of a bargaining disparity between the parties to allow the court to enforce the agreement.

In California, an indemnification agreement will also be struck down if it is considered unconscionable. Marin Storage & Trucking, Inc. v. Benco Contracting and Engineering, Inc., 89 Cal.App.4th 1042 (Cal. Ct. App. 2001). In order to determine whether an indemnification provision is unconscionable, the court will consider the clause procedurally and substantively. Id. At 653. The procedural element focuses on "oppression" and "surprise." Id. Oppression arises from an inequality of bargaining power which results in no real negotiation and an absence of meaningful choice. Id. Surprise involves the extent to which the supposedly agreed-upon terms are hidden in a pre-printed form drafted by the person seeking to enforce the agreement. The substantive element has to do with

the effects of the contractual terms and whether they are unreasonable. A contract is substantively suspect if it reallocates the risk in an objectively unreasonable or unexpected manner. Id. To be unenforceable, a contract must be both procedurally and substantively unconscionable. Id.

Sovereign Immunity Statutes: Several states statutorily protect their governmental entities from the imposition of indemnification provisions running in favor of others. For example, in Georgia, the state may not waive its sovereign immunity by entering into an indemnification agreement. CSX Transport, Inc. v. City of Garden City, 588 S.E.2d 688 (Ga. 2003).

The impact of these statutes, as a practical matter, may be minimal. The statutes need to be further examined to determine if sovereign immunity can be waived up to a policy's limits by the purchase of insurance to protect the political subdivision's liability. See e.g., Id. It may also be that the simple entering into of the indemnification agreement waives the immunity defense. National Railroad Passenger Corp. (AMTRAK) v. Roundtree Transport and Rigging, Inc., 422 F.3d 1275 (11th Cir. 2005).

Ambiguity: Despite careful drafting, many indemnification agreements do not distinctly and crisply detail the scope of the obligation imposed. These clauses are often times later challenged as being ambiguous. The following is an example of an indemnification agreement which initially seems to be clear, but on closer inspection can be read two different ways:

“The Contractor shall indemnify and hold harmless the [Owner] and [its] agents and employees from and against all claims . . . arising out of or resulting from the performance of the Work provided that any such claim . . . is caused in whole or in part by any negligent act or omission of the Contractor, . . . regardless of whether or not it is caused in part by [the Owner].”

It initially appears the language requires the Contractor to indemnify the Owner for all claims against the Owner, regardless of who is at fault. However (according to one court), the language can also be construed to mean that the Contractor is only required to indemnify the Owner for the Contractor's negligence. Therefore, the indemnification agreement is not enforceable to the extent the Owner seeks indemnification for its own negligence. Katzner v. Kelleher Constr., 545 N.W.2d 378 (Minn. 1996).

Clear and unambiguous indemnification agreements will be enforced as written. See e.g., Tubb v. Bartlett, 862 S.W.2d 740 (Tex. Ct. App. 1993) (agreement identifying parties to be liable, a clear description of the agreement's application to "all debts, and obligations, claims & demands arising out of Big Horn Energy and its subsidiaries," and supported by consideration was unambiguous and fully enforceable).

**Scope of Claims Indemnified:** Historically, indemnification agreements have addressed bodily injury and property damage exposures which may arise under the contract. However, the exposures faced in modern business arrangements far exceed the risks of physical injury to body or property. Intangible injuries such as defamation, false imprisonment, false advertising, emotional distress unaccompanied by physical injury, constructive eviction and loss or conversion of intellectual property are now just as likely to be asserted by third persons because of activities related to the contract. These liabilities must also be allocated among the parties in a properly crafted indemnification agreement.

While these clauses can be drafted with any level of protection, one approach to require the indemnitor to take on most of the indemnitee's more common potential liability is as follows:

*“[Indemnitor] shall indemnify, fully defend and hold harmless [Indemnitee] for all judgments, awards, claims, demands, and expenses (including attorneys' fees and costs incurred in the defense of any matter), for any:*

- *injury or death to any person, including [Indemnitor's] and [Indemnitee's] officers and employees;*
- *loss and damage to any physical property;*
- *personal injury or advertising injury; and*
- *other injury to any intangible property;*

*arising in any manner from [Indemnitor's] or any of [Indemnitor's] subcontractors' acts or omissions, and/or failure to perform any obligation hereunder. THE LIABILITY ASSUMED BY [INDEMNITOR] SHALL NOT BE AFFECTED BY THE FACT, IF IT IS A FACT, THAT ANY PART OR ALL OF ANY INJURY, DEATH, LOSS OR DAMAGE WAS CAUSED BY, OCCASIONED BY OR CONTRIBUTED TO BY THE NEGLIGENCE OR OTHER FAULT OF [INDEMNITEE], ITS AGENTS, SERVANTS, EMPLOYEES OR OTHERWISE.*

**Does The Indemnification Obligation Survive The Project's Completion?** Every project ends. However, the indemnitee may still wish or need the contract's indemnification agreement's protection in order to avoid exposures for liabilities which have occurred but which are unknown, or which have not yet occurred. The duration of the indemnification agreement therefore needs to be considered when the agreement is negotiated, and identified in the contract once the claim is presented to determine if the indemnitor's obligation has expired.

**Scope of Defense:** Typical indemnification agreements impose an obligation to “defend,” or “fully defend,” the other party. These words, however, may only obligate the indemnitor to defend

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the indemnitee for the claims actually indemnified.<sup>3</sup> These obligations also raise the question of which party, the indemnitor or the indemnitee, will control the defense of the claim or suit. For example, it may be unwise to have the indemnitor control the indemnitee's defense in situations where the indemnitor is also a party to the lawsuit.

In the absence of specific language beyond the mere obligation to "defend" the indemnitee, the indemnitor may well only be required to defend the indemnitee on those claims which would later be indemnified as opposed to defending other causes of action which are not subject to the indemnification agreement. This would require a tedious allocation of attorneys' fees and costs by defense counsel between indemnified and unindemnified amounts to determine which entity owes what charges.

In order to avoid this accounting quagmire, the party being indemnified should seek to have the indemnitor pay for the entire defense of the action asserted against the indemnitee, even if some of the causes of action are beyond the scope of the indemnification agreement. In addition, the indemnitee may wish to also require the indemnitor to assume all costs associated with responding to any claim asserted, even though the claim has not ripened into a formal suit or arbitration.

An example clause to address these protections is as follows:

***"[Indemnitee] agrees that its obligation to defend [Indemnitor] shall extend to any and all causes of action or claims asserted against [Indemnitor] so long as any one cause of action or claim asserted against [Indemnitee] is subject to [Indemnitor's] defense obligation assumed above. [Indemnitor] also agrees that its obligation to***

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<sup>3</sup> This scope of defense is significantly more narrow than a defense provided by an insurance policy.

***defend [Indemnitee] includes the costs incurred to adjust or otherwise handle or address any claims for which the [Indemnitee] is liable or is alleged to be liable.”***

The indemnitee also will prefer to control the defense despite the fact the other party will pay for the defense. A simple clause confirming the indemnitee’s retention of the control of its defense is as follows:

***“[Indemnitor] agrees that its obligation to defend the [Indemnitee] shall be controlled by the [Indemnitee], and that the [Indemnitee] shall, at its sole discretion, appear and defend any suits, arbitrations, actions, alternative dispute resolution proceedings and claims brought against [Indemnitee] which arise out of or are in any manner connected with any liability assumed by [Indemnitor] under this Agreement for which the [Indemnitee] is liable or is alleged to be liable.***

Without such clauses, disputes may arise between the parties if an action is later filed, and the indemnitor objects to the scope of the efforts utilized by the indemnitee to defend the claim. For example, an indemnitor could object to the retained defense firm’s hourly rate or staffing decisions, the costs of which will later be submitted to the indemnitor for payment. Prospectively negotiated clauses eliminates these disputes. Moreover, prospective negotiation of these provisions allows the indemnitor to potentially limit problems such as a “gilded” defense controlled by the indemnitee by negotiating language in these clauses to, for example, allow both parties to be involved in the counsel retention decision, or consider other possible limitations. Consider, for example, the following clauses:

***"[Indemnitee] shall promptly provide [Indemnitor] with written notice of the assertion of any claim which it asserts that falls within the scope of [the indemnification clause] (" Indemnified Claim"). [Indemnitor] shall have no duty to defend, indemnify or hold harmless [indemnitee] prior to receipt of such notice. Subject to the remaining provisions of this paragraph, [Indemnitee] shall control***

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*the defense of any Indemnified Claim. [Indemnitor] shall have the right to associate in the defense of said Indemnified Claim and to retain its own counsel to associate in the defense at [Indemnitor's] own expense; and, if [Indemnitor] associates in the defense of said Indemnified Claim, [Indemnitor] and [Indemnitee] shall jointly control the defense of such Indemnified Claim.”*

**INSURING THE OBLIGATIONS:** There generally are two obligations which will require insurance to assure that the obligations have teeth: the obligation to indemnify, and the obligation to defend.

**Insuring the Indemnity Obligation:** Most times there is an inequality of economic power between contracting parties. A smaller company is often willing to take on contractual risk in an indemnification obligation for the privilege or economic reward of doing business with the larger entity. The parties' disparate balance sheets usually raise questions as to whether the larger entity can actually collect under the indemnification clause. After all, the indemnification protection in an of itself is only as good as the indemnitor's balance sheet. Moreover, as noted above, if the economic power between the parties is too disparate, courts in some states may find the clause unenforceable as a matter of public policy.

Since the loss indemnified is generally fortuitous, the indemnitee may be able to require the clause be “funded” by the indemnitor's procurement of insurance to cover the indemnification obligation. A commercial general liability (“CGL”) policy will often contain some form of coverage for certain indemnification agreements. This is accomplished by the CGL policy first excluding coverage for contractually assumed liability, and then restoring coverage for certain indemnification

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agreements where the insured assumes the tort liability of another in an “insured contract.” Specifically, typical CGL coverage for bodily injury or property damage is excluded if “the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement.” See e.g., Insurance Services Organization (“ISO”) form CG 00 01 10 01 at p. 2.<sup>4</sup> Coverage is then restored as long as the contractual obligations taken on are liabilities “assumed in a contract or agreement that is an ‘insured contract,’ provided the bodily injury or property damage occurs subsequent to the execution of the contract or agreement.” *Id.* An “Insured Contract” is defined in the cited standard ISO form as including:

“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.”<sup>5</sup>

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<sup>4</sup> The Insurance Services Organization (“ISO”) publishes “standard” insurance forms which are promulgated from time to time by the industry. “CG” forms address commercial general liability risks. Each CG form is designated by a set of four two-digit numbers. The first two sets of numbers (here 00 01) describe the type of form involved (here, the commercial general liability base “occurrence” coverage form). The second two sets of numbers describe the edition date of the form (here 10 01 (October 2001)). It is absolutely imperative that ISO and other insurance organization “standard” forms be identified, not just by the form number, but by the edition date (or number) as significant changes likely exist between earlier and later versions of a form.

Since the October 2001 edition, ISO has introduced an updated version of the standard insuring form. See ISO form 00 01 12 04. This form is just gaining acceptance, and should be consulted if the policies at issue are based on this updated form. Most of the concepts addressed in the body of these materials have equal application to the updated form.

<sup>5</sup> This definition excepts certain operations performed near railroad property which effect structures supporting rails, and excepts certain assumptions of architect, engineer or surveyor

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*CONTRACTUAL RISK MANAGEMENT:  
CONSIDERATIONS WHEN ALLOCATING THIRD PARTY LIABILITY RISK*  
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An example of a clause which mandates this insurance procurement is as follows:

***“[Indemnitor] agrees to procure and maintain at its sole cost and expense such insurance as is necessary to insure the indemnification obligations set forth in this Agreement.”***

The coverage typically procured to insure the indemnity obligation only extends to contractually assumed bodily injury or property damage liabilities. As noted above, transacting parties today face a wide variety of exposures which have nothing to do with these physical injury coverages. Therefore, parties mandating insurance coverage for the full scope of another’s indemnification obligation should seek to have the indemnitor procure additional types of “insured contract” coverage to protect these promises as well. This will be difficult as it appears the commercial insurance market may not offer the full scope of these coverages, even in a manuscript form, at a commercially reasonable price.<sup>6</sup>

The following clause might be considered to compel the indemnitor to seek as much additional “insured contract”-type coverage as possible to protect the additional scope of a well-crafted indemnification obligation:

***“[The Indemnitor] further agrees to procure such commercial general or other liability insurance as is necessary to insure the additional obligations under the***

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liabilities.

<sup>6</sup> Some coverage for false arrest, detention and imprisonment offenses (a fraction of the enumerated “personal and advertising injury” offenses) is available under ISO scheduled form CG 22 74 10 01 entitled “Limited Contractual Liability Coverage for Personal and Advertising Injury.” However, this coverage does not address the potentially more serious trade infringement, defamation and other intangible injuries which would otherwise be covered under personal and advertising injury protections.

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*Indemnity Clause beyond bodily injury and property damage coverage as is commercially reasonable.”<sup>7</sup>*

Finally, merely inserting these clauses into the parties’ contract does not guarantee that the indemnitor actually procured the insurance. As will be discussed below in detail in the Additional Insured section of these materials, ISO materially changed several endorsements in July 2004 to limit coverage when the indemnitee is solely liable for the loss at issue. Prior to endorsements issued as of July 2004, an indemnitor would have coverage for its indemnification obligation to an indemnitee even if the indemnitee was solely liable for the loss at issue, so long as the loss had some “but for” connection to the matter involved in the contract. Coverage for the indemnification obligation under these particular circumstances was substantially reduced when ISO modified the language in its endorsement form CG 24 26 07 04. This form, typically now added to policies utilizing the 2001 editions of the standard insuring forms (CG 00 01 10 01 and CG 00 02 10 01), bars coverage for the indemnity agreement if the indemnitee is solely at fault for the loss at issue. In other words, this endorsement eliminates coverage for the indemnitor’s indemnification agreement if the indemnitee is solely at fault for the loss. Moreover, form CG 24 26 07 04 was further modified to limit the scope of causation required to have this “Insured Contract” coverage apply to the indemnification agreement. If this form is included in the indemnitor’s policy, the liability under the indemnification agreement will only be covered if the injury or damage was “caused by” as opposed to “arose out of” the indemnitor or those acting on the indemnitor’s behalf. This is why the party benefitting from the

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<sup>7</sup> Whether such coverage is 1) available, and 2) at a “commercially reasonable” price, is a question better directed to the insurance broker or agent.

indemnification obligation must obtain a copy of the indemnitor's actual insurance policy to confirm the "Insured Contract" coverage actually exists in light of the state law that will apply to the insurance policy, and that the policy does not contain any endorsements which jeopardizes Insured Contract coverage if the indemnitor is solely at fault for the loss, or if the causal connection between the indemnitor and the loss does not meet the requisite standard.

As noted above, mandating insurance to cover the indemnification obligation may avoid problems in states where sovereign immunity statutes limit enforcement of indemnity clauses against governmental entities unless the obligation is insured. CSX Transport, Inc. v. City of Garden City, 588 S.E.2d 688 (Ga. 2003). This duty to procure clause may also assist the indemnitee in defeating provisions of a state's Anti-Indemnification Statute. See e.g., Minn. Stat. § 337.05, Subd. 2; Holmes v. Watson-Forsberg Co., 488 N.W.2d 473 (Minn. 1992).

**Limited Contractual Liability Indemnification Coverage for False Arrest, Detention and Imprisonment Personal Injury Offenses:** If the indemnitee seeks indemnification for intangible injuries, it needs to determine if these liabilities are not only indemnified, but whether the obligation is also insured under the indemnitor's policy. A "standard" CGL policy will likely include coverage for personal injury and advertising injury offenses. However, this coverage section usually also includes a broad exclusion to bar coverage for personal injury and advertising injury "for which the insured has assumed liability in a contract or agreement." Form CG 00 01 10 01 at p. 6. Therefore, even if the indemnitee bargained for indemnification of these additional liabilities, there

usually will not be coverage available for the indemnitor's obligation unless the indemnitee's standard policy provisions have been modified.

The insurance industry recognizes that contractual liability coverage for at least some of these exposures (false arrest, detention and imprisonment) is marketable. ISO Form CG 22 74 10 01, entitled "Limited Contractual Liability Coverage for Personal and Advertising Injury" provides an insured with coverage for an indemnification agreement which assumes the indemnitee's liability for these specific offenses. Therefore, especially in security-related claims, this coverage should be part of a risk manager's demands when negotiating with a another party, and should be looked for in the other party's policy to be sure indemnification coverage is available for these intangible losses.

Because the insurance industry provides this limited endorsement, it may well be that the indemnitor's CGL carrier will reject attempts to expand the exceptions in this endorsement on a manuscript basis to have the indemnitor covered for *all* contractually-assumed personal injury and advertising injury liability. However, this limited indemnification coverage for some personal injury and advertising injury offenses is better than nothing.

**Insuring The Indemnitor's Defense Obligation:** If there is Insured Contract coverage for settlements or judgments under the indemnitor's CGL policy for bodily injury, property damage or other injury, there is a question as to how the indemnitee's defense fees, costs and disbursements will be paid. A standard CGL policy form contains two separate provisions which apply to pay these amounts.



The first provision is found in the standard CGL policy's "Supplementary Payments" provision. This provision states that, so long as the following conditions are met, the indemnitor's CGL carrier will defend the indemnitee in an action where both parties are named as defendants:

- a. The "suit" against the indemnitee seeks damages for which the indemnitor has assumed the liability of the indemnitee in a contract or agreement that is an "insured contract";
- b. The indemnitor's CGL policy applies to the liability assumed by the indemnitor;
- c. The obligation to defend, or the cost of the defense of, the indemnitee has also been assumed by the indemnitor in the same "insured contract";<sup>8</sup>
- d. The allegations in the "suit" and the information the carrier knows about the "occurrence" are such that no conflict appears to exist between the indemnitee's and the indemnitor's interests;
- e. The parties each ask the carrier to conduct and control the indemnitee's defense, and further agree that the carrier may assign the same counsel to defend both of the parties; and
- f. The indemnitee:
  - (1) agrees in writing to:
    - (a) cooperate with the carrier in the investigation, settlement or defense of the "suit";
    - (b) immediately send the carrier copies of any demands, notices, summonses or legal papers received in connection with the "suit";
    - (c) notify any other insurer whose coverage is available to the indemnitee; and

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<sup>8</sup> This is another reason to mandate that the indemnitor defend the indemnitee.

- (d) cooperate with the carrier with respect to coordinating other applicable insurance available to the indemnitee; and
- (2) provides the carrier with written authorization to:
  - (a) obtain records and other information related to the “suit”; and
  - (b) conduct and control the defense of the indemnitee in such “suit.”

ISO Form CG 00 01 10 01 at p. 8.

So long as these numerous conditions are met, the carrier will pay the defense expenses “in addition to limits” of the indemnitor’s indemnity coverage (i.e., the defense expenses will not erode the indemnity limits of insurance).

If the Supplementary Payments provision does not apply, there is another provision which is available to pay the indemnitee’s defense fees and costs. This language is found in the standard ISO form policy’s bodily injury and property damage “Contractual Liability Exclusion:”

“Solely for the purposes of liability assumed in an “insured contract,” reasonable attorneys’ fees and necessary litigation expenses incurred by or for a party other than an insured are deemed to be damages because of ‘bodily injury’ or ‘property damage,’ provided:

- “(a) Liability to such party for, or for the cost of, that party’s defense has also been assumed in the same ‘insured contract’;<sup>9</sup> and
- “(b) Such attorneys’ fees and litigation expenses are for defense of that party against a civil or alternative dispute resolution proceedings in which damages to which this insurance applies are alleged.”

ISO Form CG 00 01 10 01 at p. 2.

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<sup>9</sup> Again, this is yet another reason to mandate that the indemnitor defend the indemnitee.

This provision provides the indemnitee with the ability to have its defense fees and costs paid pursuant to a defense provision in the indemnification agreement in situations where the carrier does not control the defense. However, this comes at a “cost;” any defense fees and costs expended will erode the CGL policy’s indemnity limits.<sup>10</sup> The additional limitation in accessing this coverage for defense costs is that it is only available if the damages at issue are because of bodily injury or property damage, and not intangible injury.

The Supplementary Payment Provisions and the Contractual Liability Exclusion discussed above are fairly recent changes to the standard form CGL coverage. Prior to these provisions’ inclusion in the standard CGL form, numerous coverage disputes arose as to whether defense expenses were included within the “assumption of tort liability of another.” An example of the difficulties caused by the lack of this type of language in the policy is seen in a recent Minnesota case, Soo Line Railroad Co. v. Brown’s Crew Car of Wyoming, 694 N.W.2d 109 (Minn. App. 2005). In Brown’s, the contractor agreed to indemnify and defend the railroad for any loss related to the contractor’s car transportation services. An automobile accident injured two of the railroad’s employees while they were riding in one of the contractor’s cars. The employees later sued several third parties. One of the third parties in turn sued the railroad for indemnification or contribution.

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<sup>10</sup> Another reason to obtain the indemnitor’s insurance policy is to see if these defense expense provisions have been modified by endorsement. For example, there are policy endorsements which can be utilized in Minnesota which eliminates the onerous mandates in the Supplementary Payments Provision as well as the provisions in the exception to the contractual liability exclusion. These endorsements can have the effect of assuring that the defense costs incurred are paid “in addition to limits.”

The railroad tendered the suit to the contractor under the indemnification agreement in place between the parties. The contractor refused to defend the railroad. Ultimately, the underlying case was settled, apparently without the railroad participating in any of the settlement funding.

The contractor's carrier challenged the railroad's claim that the carrier covered the contractor's obligation to defend the railroad. The carrier argued that the contractor's assumption of the obligation to pay defense fees and costs was not an assumption of "tort liability" of the railroad, especially when the railroad was not found at fault in the underlying litigation. Such an interpretation, which had support in at least one other jurisdiction, would have left the contractor, and not the carrier, obligated to pay the railroad's defense expenses in any situation where the railroad was ultimately not at fault (either because no settlement monies would be contributed on behalf of the railroad, or because the fact finder found the railroad was not at fault).

The court rejected the CGL carrier's technical application of the Insured Contract language. In so doing, the Court determined that defense costs are inseparable from the underlying events of the accident which gave rise to the indemnification claim. Since the fees and costs were incurred in defense of a tort claim, they are compensable to the railroad under the indemnification agreement, and are insured under the exception to the Contractual Liability Exclusion as an "Insured Contract." The Court was not swayed by the carrier's argument that the attorneys' fees and legal expenses were not a claim for liability to pay for bodily injury, but were a claim for liability to pay fees and expenses, items which did not meet the policy's "bodily injury" definition.

Other courts have held that the “duty” to defend in an indemnification agreement is only invoked when there is, in fact, a duty to indemnify. Therefore, a carrier might be able to properly withhold costs related to the indemnitee’s defense until it was determined whether the indemnitee was in part liable for the loss at issue. See e.g., Carlson v. Consolidated Rail Corp., 105 F.Supp.2d 901 (Ill. 2000); Laiho v. Consolidated Rail Corp., 4 F.Supp.2d 45 (D. Mass. 1998); Grand Trunk Western Railroad, Inc. v. Auto Warehousing Co., 686 N.W.2d 756 (Mich. App. 2004). However, depending on the applicable state law, a party may be able to avoid a specific adverse liability finding as a condition precedent so long as there was *potential* liability, and the indemnitee had tendered the defense to the indemnitor. Auto Warehousing, 686 N.W.2d at 763.

In sum, Brown’s and the other cases cited underscore that there may be considerable problems associated with determining whether and how the indemnification agreement’s “defense” provisions are covered. The recent defense costs changes in the Supplementary Payment provision and the Contractual Liability Exclusion should be sufficient to compel the Contractor’s CGL carrier to immediately pay for the indemnitee’s defense, subject to a later resolution of whether the defense is “in addition to limits,” or will erode the indemnitor’s coverage limits.

What remains unsettled with these recent changes to the Supplemental Payments provision and the Contractual Liability Exclusion is the issue of whether the indemnitor’s insurer must pay to defend all the claims asserted against the indemnitee, or whether the insurer need only pay for the claims for which the indemnitor is obligated to indemnify. The standard rule in virtually every jurisdiction is that the insurer’s duty to defend the insured includes an obligation for the carrier to

defend *all* the allegations asserted against the policyholder, even if some of the claims are not covered by the policy. See e.g., Prahm v. Rupp. Constr. Co., 277 N.W.2d 389 (Minn. 1979). See, e.g., Western Am. Ins. Co. v. Moonlight Design Inc., 95 F.Supp.2d 838, 842 (N.D. Ill. 2000). However, the indemnitee (based just on the indemnification agreement) is not an “insured” under the policy, and therefore an argument exists to say these provisions do not compel the insurer to fully pay for all the indemnitee’s defense costs.

The question also arises as to whether the indemnitor’s carrier has the right to control the indemnitee’s defense, including having the sole say in deciding what law firm will defend the indemnitee. Compliance with the “Supplementary Payments” provisions appears to put the indemnitee into the same position as an insured under the policy, and may therefore provide the carrier with an argument that it controls the indemnitee’s defense as it has a “duty to defend” the indemnitee. The same is not true, however, for the payment provisions found in the standard form Contractual Liability Exclusion. Here, it appears the carrier only pays for defense expenses and does not have a duty to defend. Also, the carrier may have the ability to limit its payments for the indemnitee’s defense to only those amounts which were incurred with regard to the indemnified obligations. It is possible this is how the indemnitee would prefer the situation, especially if the claims asserted are all subject to the indemnification agreement, the liability is remote, the indemnity limits are high, and the indemnitee can retain its own chosen counsel. However, payments under these provisions will erode coverage limits.

Inevitably, there will be circumstances where the indemnitee will have concerns about whether or not there are sufficient coverage limits to pay for both the defense costs and the alleged liability. In these situations, the indemnitee may consider having the carrier-appointed counsel defend under the Supplementary Payments provision which provides for payment of unlimited defense costs, and simultaneously retain shadow defense counsel to monitor the proceedings. Then, if a situation arises where the indemnitee wishes to actively control the defense, shadow counsel is ready and able to immediately substitute in as defense counsel. Of course, shadow counsel's defense costs incurred until that point would be the indemnitee's personal responsibility, and payment of the costs would erode the indemnity limits after shadow counsel takes over active case management. However, this approach may well be an approach which preserves as much of the indemnity limits as possible.

As intimated above, there are no similar defense payment provisions contained in the standard policy form's personal injury and advertising injury Contractual Liability Exclusion. This is logical given that the exclusion is very broadly written and does not contain the exceptions set forth in the policy's bodily injury and property damage coverage counterpart. As well, the ISO standard Limited Contractual Liability Coverage for Personal and Advertising Injury Endorsement does not contain provisions to allow defense costs to be paid. Therefore, whether the carrier would be required to pay costs incurred to defend false arrest, detention and imprisonment claims will turn on whether such expenses fit within the policy's coverage language. Under positions analogous to the Brown's decision cited above, the indemnitee may have a good argument to say the indemnitor's coverage is

obligated to pay for defense expenses related to these personal injury offenses (likely within the policy's indemnity limits).

**Survival of The Duty to Procure Insured Contract Coverage:** As discussed above, every business transaction ends. However, the indemnified party may still wish or need the insurance covering the indemnification agreement to also remain in effect after the business transaction is completed in order to avoid exposures for liabilities which have occurred but are unknown, or which have not yet happened. The duration of the duty to procure insured contract coverage therefore needs to be determined when the agreement is negotiated.

In order to be sure that the indemnity obligation is insured after the contract is completed, a clause should be added to the agreement to confirm that the duty to procure this insurance survives the business transaction's termination or expiration. A simple clause underscoring this concept is as follows:

*“The parties agree that the indemnification agreement and the duty to insure the obligation to defend and indemnify [Indemnitee] as set forth in this Agreement shall survive the expiration or termination of this Agreement.”*

The parties should be aware, however, that “standard” insurance forms will evolve over time. Especially if “products” or “completed operations” risks are implicated in the business transaction, a party agreeing to indemnify another and to procure insurance for that obligation should examine its CGL policies each time it renews its coverage to be sure coverage continues to exist for the indemnification obligation. Only in this fashion can the indemnifying party confirm it is complying with the business transaction.



If a party is concerned there may not be commercially available “Insured Contract” coverage for such an obligation in the future, then that party may wish to consider adding the following to the agreement:

*“Notwithstanding the above, [Indemnitor’s] duty to insure its obligation to defend and indemnify [Indemnitee] as set forth in this Agreement shall terminate when [Indemnitor] determines insurance for such an obligation is not commercially available at a reasonable premium[, and notifies [Indemnitee] of the termination of this obligation].”*

This clause introduces vague concepts of “commercial availability” and “reasonable premium” which would only (likely) be decided by expensive litigation in later years. However, this clause at least provides the indemnitor with some ability to terminate the insuring obligation.

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## **DUTY TO PROCURE INSURANCE AND ADDITIONAL INSURED COVERAGE**

Naturally, whenever one company does business with another, the company’s risk of third party liability is inevitably altered in some way. The issue, therefore, is who should take on the altered risk arising from the transaction. Since insurance is designed to protect against fortuitous losses realized from a businesses’ risk, insurance is a logical vehicle to ultimately assume the altered risk and to therefore pay for the losses realized.

The question then becomes: what insurance will take on that risk? The business transaction allows the parties to designate which coverage will protect against the altered risk. While some of

these dynamics are discussed above, the most attractive and cost-effective strategy to address this risk is to designate the insurance which will be applicable to ultimately respond to the third party loss.

Despite their “common” use, insurance provisions oftentimes do not accurately reflect the parties’ risk transference intent, and therefore could become either partially or completely illusory unless the parties understand the implications of the language used in light of the insurance contract(s) intended to take on the designated risk. The following highlights some of the more common dynamics which should be considered when crafting well thought out insurance provisions.

Preliminarily, the parties must be cognizant of what state law will apply to the business transaction, and therefore, the insurance provisions. A few states have enacted variations of Anti-Indemnification Statutes to not only prohibit enforcement of certain indemnification agreements, but to also prohibit enforcement of clauses mandating certain insurance provisions also included in the business transaction. Two examples of such statutes are in Oregon and New Mexico. Oregon’s Anti-Indemnification Statute, Ore. Stat. § 30.140, has recently been interpreted in Walsh Constr. Co. v. Mutual of Enumclaw, 104 P.3d 1146 (Or. Jan. 27, 2005) in just such a fashion. In Walsh Constr., the Oregon Supreme Court held that Oregon’s Anti-Indemnification Statute in construction contracts is drafted in a manner which voids any clause compelling the indemnitor to also name the indemnitee as an Additional Insured under its CGL policy. Therefore, as a preliminary matter, and while somewhat unusual, it is incumbent on the parties to determine if the applicable jurisdiction’s statutes and caselaw permit such clauses in a business transaction.

Another key issue involved with insurance provisions is whether the language utilized accurately reflects the parties' risk transference intent. For example, one party may wish to be added to the other's policy as an additional insured. However, simply utilizing a "standard" ISO "Additional Insured" endorsement to add the party to the other party's policy may not effectuate the parties intent because of limitations in the endorsement language. Therefore, each party must have a good working knowledge of the other party's insurance program and its specific provisions to confirm whether or not the actual insurance in place accurately reflects the parties' intent.<sup>11</sup>

**DUTY TO PROCURE INSURANCE:** The parties to a business transaction will likely already have insurance to protect them against their third party liability exposures. However, the parties should be specifically obligated in the agreement to procure and maintain such insurance so that one party to the agreement has some comfort in knowing there will be some insurance available to protect the other party if needed.

An example clause mandating insurance for each of the parties is as follows:

*"Each party agrees to procure and maintain at its sole cost and expense such public liability, bodily injury, property damage, premises, operations, completed operations, personal injury, advertising injury, [errors and omissions, manufacturing errors and omissions] and contractual liability coverages as are*

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<sup>11</sup> Since indemnification agreements and insurance provisions are usually nested together in a business transaction, an indemnitor oftentimes will also be required to name an indemnitee as an additional insured under the indemnitor's CGL policies. This distinction between parties ("indemnitor" and "indemnitee") will be utilized in this section's discussion to differentiate between the two parties even though the indemnification status has no material bearing on the insurance issues.

*necessary to insure the party's liability to third persons which would relate to or which may arise out of this Agreement.”*

**Coverage Limits:** Typical duty to procure insurance provisions mandate that the parties maintain CGL and other liability insurance with specific limits of coverage to protect against the parties' own liabilities. An example of this type of clause is as follows:

*“The commercial general or other insurance liability insurance called for in this Agreement shall provide for coverage limits of \$X,000,000.00 for each occurrence [claim], with separate \$Y,000,000.00 limits for each general aggregate, products-completed operations aggregate, personal and advertising injury aggregate, and other aggregate limits called for in this Agreement.”*

The clauses addressing the amount of insurance limits to maintain implicate a variety of issues which the parties need to prospectively address. For example, the parties' agreement may require that the coverage limits to be maintained are different than the party's limits already available in its insurance program. If the amount mandated by the agreement is less than a party's uneroded limits, then, at least initially, this is not an immediate concern. However, if the mandated limits exceed a party's policy limits, or if claims paid under the existing policy erode the limits to a level which is below the mandated amounts, a party may find itself violating the business agreement. An additional concern is how the agreement will address an erosion of coverage limits by claims contemplated by the transaction which happen subsequent to the parties entering into the agreement.

These types of issues underscore that the business transaction needs to address whether and/or how a party, especially the indemnitor, should provide notice of policy erosion limits as of a certain point, and/or whether the party should be compelled to replenish the limits at some point. As a practical matter, these “notice” provisions are cumbersome, and rely on a later events which would

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cause a party to originate a communication which is outside of its normal business activities. Therefore, it would be very easy for even a conscientious party to overlook providing the other party with a mandated notice until it is too late.

Instead, a better approach may be to have the parties agree the policies should include an “amendment of limits” form which provides specific separate limits for the operations, activities, products and/or completed operations encompassed in the business transaction. There are a variety of forms to consider. For example, ISO form CG 25 01 07 98 addresses “Amendment of Limits of Insurance (Designated Project or Premises).” This endorsement has the ability to modify the limits of all the coverages available under the applicable policy to the level of coverage mandated in the agreement.

The shortcoming with this form is that it does not create separate limits which would be *solely* applicable to the agreement. The limits under this endorsement continue to be exposed to erosion by liability claims which are unrelated to the business transaction. This form is also impractical when the scheduled limits in the agreement are actually less than the CGL limits in the policy because there is no reason to artificially limit the amount of coverage available if the coverage limits already stated are higher than those called for in the business transaction.

It is possible the parties may be satisfied with merely amending the policies’ “general aggregate” limits as part of the transaction. If so, the parties could mandate that ISO form CG 25 04 03 97 (“Designated Location(s) General Aggregate Limits”) or its “construction” sibling, form CG 25 03 03 97 (“Designated Construction Project General Aggregate Limits”) be

utilized. These “scheduled” forms establish a separate general aggregate limit for the applicable policy which will be specifically and only applied to the scheduled project or location. In other words, only claims related to the Designated Location(s) will erode these separate limits. This form therefore assures the parties that specifically stated limits will be available if needed.

There are a few shortcomings with these forms as well. Initially, the forms do not alter the insured’s CGL policy’s per-occurrence limits. In addition, the forms do not provide a separate “completed operations” aggregate limit; by definition, the new separate aggregate limit only applies to “ongoing operations.” Also, these forms do not provide a separate aggregate limit for personal injury and advertising injury exposures for offenses such as defamation, false advertising, etc. Finally, the insured may still be faced with an issue as to whether it should or is compelled to refresh the separate aggregate limits if more than one claim is made against the policy.

These various coverage limit forms are all scheduled forms which require identification of the specific project. The preferred language for scheduling projects to avoid additional paperwork would be to utilize a phrase in the schedule which states that the limits apply to all projects in which the indemnitor engages. Example blanket language to avoid additional paperwork processing is as follows: ***“Apply separately to each of your projects away from premises owned by you or rented to you.”*** This in fact was the approach utilized in Form CG 25 03 before 1997. This language was omitted in the 1997 edition because of potential concern about an indemnitor’s liability which may relate to several projects such as when an indemnitor stores materials or equipment at a single location, and liability arises because of the storage of that equipment. The claims professional should

look at the description of the designated project to be sure the description imposes a separate set of limits to the specific location at issue.

There are additional options available to obtain separate completed operations coverage limits if that is what is needed by the parties. The insurance industry recognizes certain “manuscript” forms which provide for separate completed operations aggregates for a scheduled project. *Commercial Liability Insurance* (International Risk Management Institute, Inc.), at VII.E.3. An example manuscript form is as follows:

“Only with respect to your project’s schedule below, the General Aggregate Limit and the Products-Completed Operations Aggregate Limit under the Limits of Insurance (Section III) apply separately to each project.

“With respect to all your other projects, premises, and locations not specifically scheduled in this endorsement, the General Aggregate Limit and the Products-Completed Operations Aggregate Limit shown in the Declarations apply in accordance with the Limits of Insurance (Section III) of this policy.”

Id. As seen, this form provides separate products-completed operations coverage for a project. However, the form does not provide for a separate personal injury and advertising injury limit. Therefore, the parties may wish to consider modifying this manuscript form even further to include a requirement that a separate personal injury and advertising injury aggregate limit be included.

Language to consider as part of the agreement which addresses the need for separate limits to be applied to the obligations in the business transaction is as follows:

***“The [Indemnitor] agrees the limits of insurance called for in this Agreement shall be provided as separate limits under its commercial general or other liability policies to protect for any and all liabilities which relate to or which may arise out of the Agreement.”***

When addressing modification of coverage limits, as with several other of the insurance issues involved in these materials, the parties should confer with their insurance broker(s), agents or representatives to be sure the insurance policies are properly modified to reflect the parties' intent in the business transaction.

**Occurrence vs. Claims-Made Coverage:** The majority of bodily injury and property damage liability insurance in the United States is written on an "occurrence" basis. Occurrence coverage forever protects an insured for liability related to bodily injury or property damage which happens during the time the policy is in effect. Most often, the timing of the bodily injury or property damage is readily ascertainable, and therefore application of occurrence coverage (the "trigger") is fairly straight forward. In situations where the timing of the injury or damage is uncertain, occurrence coverage will also provide protection for the bodily injury or property damage occurring during the time the policy was in effect, even if the claim was made years after the policy expired. This is the "tail" coverage aspect of occurrence policies.

In contrast, many liability policies are written on a "claims-made" basis. Generally, this coverage protects an insured for liabilities which are asserted during the time the policy is in effect as opposed to when the bodily injury or property damage happened. Claims-made coverage has its own set of "trigger" rules which relates to when the claim is made against the insured, the insured's knowledge of the claim or suit at issue, whether the carrier is notified of the claim or suit within policy period or possible extended reporting periods, etc. Key, however, is that the claims-made



coverage generally expires once the policy ends, and can not be called upon in later years to cover the bodily injury or property damage happening when the policy was in effect.

The parties to the business transaction need to confirm what type of coverage (occurrence vs. claims-made) is contemplated by the insurance provisions. Without confirming the coverage type, unforeseen problems can arise. Therefore, in order to avoid these problems, the agreement should specifically spell out what type of coverage is contemplated:

*“The [Indemnitor] shall procure the liability insurance mandated in this Agreement on an [occurrence] [claims-made] basis.”*

**Insurance Carrier Rating Requirement:** Most insurance carriers have the financial strength necessary to meet the risks it assumes in its business. However, a variety of economic or other pressures can arise which may call into question the insurer’s ability to respond to claims or suits arising from the business transaction. To provide the parties with some level of comfort about the stability of an insurer, the parties may wish to consider limiting the universe of carriers from whom insurance is procured to protect the business transaction to those who meet some defined minimum financial stability as identified by various rating bureaus. An example of such language is as follows:

*“The parties agree all insurance to be procured and maintained pursuant to this Agreement shall be placed with insurance companies licensed to do business in the States in which the parties conduct their operations and activities called for in this agreement, and hold a current Best's Insurance Guide Rating of A- and Class VII, or better.”<sup>12</sup>*

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<sup>12</sup> A.M. Best is one of the most widely recognized insurance financial rating organizations in the United States. A discussion of A.M. Best’s Ratings can be seen at <http://www.ambest.com/ratings/about.asp> (last visited March 27, 2006).

**ADDITIONAL INSURED OBLIGATION:** The most common form of designating the insurance which is intended to respond to a loss is the use of an “Additional Insured” clause in a business agreement. This provision requires one of the parties to the business transaction, usually the entity agreeing to indemnify the other, to add the indemnitee as an additional insured on its liability policies. The practice is widespread and well accepted within the insurance industry. Even if a state law prohibits enforcement of an indemnification provision with regard to the indemnitee’s liability, most states will enforce the agreement to procure insurance to protect the indemnitee for its own liability. See e.g., Chrysler Corp. v. Merrell & Garaguso, Inc., 796 A.2d 648 (Del. 2002) (agreements to procure insurance to protect another for its liability valid even if an indemnification obligation providing the same type of protection is invalid); Sherwin-Williams Co. v. Fred Burgland & Sons, Inc., 799 F.Supp. 64 (N.D. Ill. 1992) (same).

A clause mandating Additional Insured status is fairly simple:

***“[Indemnitor] shall identify and add [Indemnitee] as an additional insured under all commercial general or other liability insurance the Indemnitor must procure pursuant to this Agreement.”***

Despite the fact it is “common” to add another entity as an additional insured onto a policy, there are numerous pitfalls which can easily result in no coverage being available to the indemnitee unless these issues are addressed at the time of contracting. As well, parties analyzing Additional Insured issues after a loss need to be equally cognizant of these issues so they are able to determine whether or not this additional coverage is available to the indemnitee.

**State Statutory Prohibitions on Additional Insured Enforcement:** Preliminarily, a few states' Anti-Indemnification Statutes not only prohibit contractual indemnification of another's liability, but some of these statutes also bar the indemnitee from compelling the indemnitor to procure CGL coverage by adding the indemnitee as an Additional Insured under its CGL policy. Two examples of such statutes are Oregon and New Mexico. Oregon's Anti-Indemnification Statute, Ore. Stat. § 30.140, has recently been interpreted in Walsh Constr. Co. v. Mutual of Enumclaw, 104 P.3d 1146 (Or. 2005) in just such a fashion. In Walsh Constr., the Oregon Supreme Court held that application of that state's Anti-Indemnification Statute in construction contracts voids any clause compelling the indemnitor to also name the indemnitee as an Additional Insured under its CGL policy. This underscores that the relevant jurisdiction's statutes and caselaw must be analyzed to determine if there is any legal bar to the indemnitee being named as an Additional Insured in the indemnitor's CGL policy.

**Issues Involved With Duty To Procure Insurance Also Apply When Addressing Additional Insured Issues:** Because Additional Insured coverage is provided by the indemnitor's insurer, the indemnitee must confirm that all the issues discussed above regarding the indemnitor's duty to procure insurance are addressed as it is anticipated that the indemnitor's coverage would apply to respond to the indemnitee's loss. Therefore, the indemnitee must confirm that proper:

- coverage limits pursuant to the proper endorsement;
- type of coverage (occurrence vs. claims-made) is provided; and
- insurance carrier viability

be mandated in the business transaction.

**Additional Insured Endorsements and the Scope of Protection Under Applicable Endorsements:** Once the parties agree an Additional Insured provision should be included in the risk allocation, the question becomes what provision or endorsement will be utilized in the indemnitor's insurance policy to provide the Additional Insured status. "Standard" ISO CGL coverage forms only provide automatic Additional Insured status in certain limited situations for certain entities involved with the insured in a business transaction. Therefore, an Additional Insured status in the insurance policy typically must be created by adding an endorsement to the indemnitor's policy.

ISO has developed over 30 Additional Insured forms for use depending on the facts and circumstances involved in a business transaction. The vast majority of these forms only extend Additional Insured status to an indemnitee with regard to the indemnitor's ongoing operations or the indemnitor's premises. In other words, the typical Additional Insured endorsement addresses coverage with regard to day-to-day premises and operations activities as opposed to providing additional insured protection for risks associated with products in the stream of commerce or projects which have already been completed and therefore create "completed operations" exposures. For example, a typical form utilized when the indemnitor is providing a service for the indemnitee is ISO Form CG 20 10. An example of a form which extends Additional Insured status in certain products liability situations is ISO form 20 15 which provides Vendors with Additional Insured status in a manufacturer's or distributor's policy under specific circumstances. ISO also has a "generalized" form which is often utilized in situations which do not readily fit the other forms. ISO form 20 26.

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*CONTRACTUAL RISK MANAGEMENT:*

*CONSIDERATIONS WHEN ALLOCATING THIRD PARTY LIABILITY RISK*

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Additional Insured forms are typically “scheduled” forms which require that the indemnitee’s name (and sometimes additional information) be specifically stated on the endorsement before coverage will attach. There are also forms which will identify an indemnitee as an additional insured based on the obligation the indemnitor takes on in the business transaction. However, such forms must already be part of the indemnitor’s CGL policy before the business transaction in order to have an “automatic additional insured” status apply.

**Impact of the 07 04 Edition Changes to ISO Additional Insured Endorsements:** Usually, parties to a business transaction contemplate that the Additional Insured status will completely pick up all of the parties’ liabilities if the loss arises out of or relates to the agreement. This contemplation necessarily includes the liability of the indemnitee, even if the indemnitee is solely at fault for the loss at issue. However, as referenced in the discussion above relating to the insurability of an indemnification agreement, recent changes to standard ISO forms underscore that the insurance industry is no longer interested in having the indemnitor’s policy take on the indemnitee’s risk in situations where the indemnitee is solely at fault for the transaction-related loss. In 2004, the insurance industry implemented comprehensive changes to its Additional Insured Endorsements. All ISO Additional Insured forms, and nearly all of the and Insured Contract forms, were “updated” in July of that year (the “07 04 Editions”) to “clarify” the scope of coverage the indemnitee is provided as an additional insured under the indemnitor’s CGL policy. This “clarification” of coverage is, in fact, a substantial reduction in coverage available to the indemnitee under the indemnitor’s policy. The 07 04 Editions of the ISO Additional Insured endorsements eliminate coverage for the

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indemnitee under the indemnitor's CGL policy if the indemnitee is solely at fault for the injuries or damages at issue. The 07 04 Editions also now require there be a causal connection between the indemnitor and the loss as opposed to there just being some connection. The following details how these changes impact the indemnitee's scope of coverage under the indemnitor's CGL policy under these endorsements.

Prior to the insurance industry's 2004 standard policy language revisions, the Additional Insured status under the indemnitor's policy covered the indemnitee for liability "arising out of" either the indemnitor's "work" or "ongoing operations" (depending on the form edition) performed for the indemnitee. "Arising out of" is not the same as a "proximate cause," or even a "causal," relationship. Instead, a more remote "but for" relationship between the parties can exist, and coverage would still exist under the policy. "Arising out of" in essence means originating from, or having its origin in, growing out of, or flowing from. See, Associated Indep. Dealers, Inc., v. Mutual Serv. Ins. Cos., 304 Minn. 179, 182, 229 N.W.2d 516, 518 (1975).

An example of this "but for" interpretation is seen in Andrew W. Youngquist v. Cincinnati Ins. Co., 625 N.W.2d 178 (Minn. App. 2001). In Youngquist, a subcontractor's employee was injured on a building construction site while providing subcontracted-for electrical work. There did not appear to be any fault or negligence on either the employee or the subcontractor. The contractor was listed as an Additional Insured under the subcontractor's policy. The endorsement utilized to add the contractor as an Additional Insured utilized the "arising out of" language. Under these circumstances, the court had no problem in finding that the subcontractor's policy insured the

contractor for CGL coverage as the injury “arose out of” the subcontractor’s work (and not the subcontractor’s fault). Moreover, the court did not require that the contractor be vicariously liable for the injury in order for coverage to attach.

Recent changes in the standard ISO Additional Insured forms attempt to narrow the circumstances under which the CGL carrier will be required to cover the Additional Insured. First, the 2004 editions eliminate the “arising out of” language, and replaces it with the term “caused . . . by.” Therefore, there must be a more direct relationship between the indemnitor’s ongoing operations and the loss in order for the policy to cover the Additional Insured. While there are few, if any, reported cases in the country directly interpreting this change as of yet, older cases analyzing similar issues support the carrier’s argument that the “caused . . . by” language requires an actual causal relationship between the indemnitor’s work (which likely imposes liability on the indemnitor or its subcontractors) and the indemnitee’s liability.

In Consolidation Coal Co. v. Liberty Mut. Ins. Co., 406 F.Supp. 1292 (W.D. Pa. 1976), a contractor agreed to haul coal for a coal company. The contractor’s policy listed the coal company as an additional insured under the policy, “*but only with respect to acts or omissions of the named insured* in connection with the named insured’s operations at [the coal company’s] premises.” Id. at 1294. One of the contractor’s employees was injured while working on the job, and brought suit against the coal company. He claimed one of the coal company’s employees was the sole and proximate cause of the accident. Id. In response to this allegation, the coal company sought insured status under the contractor’s policy.

The carrier argued the policy did not cover the coal company for this accident because the accident was not caused by the negligence (“acts or omissions”) of the contractor, but was instead solely caused by the coal company. *Id.* at 1295. In opposing the carrier, the coal company argued that, “but for” the employee’s presence on the job site in connection with the contractor’s operations, the accident would never have happened. *Id.* The court rejected the coal company’s arguments, but not without going into some interesting analysis of the policy’s provisions.

First, the court determined that the language “but only with respect to the acts or omissions” as utilized was ambiguous. *Id.* Therefore, the court engaged in an analysis of the language to ascertain the parties’ intent with regard to the language. *Id.* at 1296. In so doing, the court made it clear there was no “arising out of” language involved in this case. *Id.* Further, if the court were to adopt the more liberal interpretation of the language, it would end up “reading out” the key provision on which the case turned, an outcome courts generally disfavor. This principle, along with an examination of other cases utilizing the phrase “acts or omissions,” ultimately lead the court to determine that the “but only with respect to acts or omissions of the named insured” language required a causal connection, and not a “but for” relationship, between the contractor and the coal company’s liability to provide the coal company with coverage under the contractor’s policy. *Id.* at 1298-99.<sup>13</sup>

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<sup>13</sup> This court reaffirmed the broader nature of the “arising out of” language when it held in *Steadfast Ins. Co. v. Liberty Mutual Ins. Co.*, (E.D. Pa. March 8, 2000) that utilizing this language in a similar additional insured passage *does* invoke the desired status.



Similarly, in Shaffer v. Stewart Constr. Co., 865 So.2d 213 (La. App. 2004), cert. denied, 869 So.2d 886 (La. 2004), a contractor agreed to build a mooring facility for a new casino barge. Id. at 215. The contractor rented equipment from a company as part of this job. The equipment malfunctioned on the job site, and one of the contractor's employees was injured in the process of repairing the equipment. The employee thereafter brought suit against the equipment lessor, who requested that the contractor's carrier defend and indemnify the lessor pursuant to, among other provisions, an additional insured provision. In the subsequent lawsuit, the contractor's carrier alleged its additional insured coverage was excluded when the "sole negligence" of the additional insured caused the injuries. Id. at 223. The court rejected this argument as it was apparent the accident was not caused "solely" by the lessor, as other parties also appeared to be liable in some degree. Id.

Consolidation Coal's chief point, intuitively supported by Shaffer, is that policy language utilizing fault or liability concepts such as "caused by" will require a greater connection between the injury and the indemnitor's work than a "but for" association to meet the provision's requirements. Therefore, the newer ISO forms' Additional Insured language, if seen in an indemnitor's policy, will impose a greater requirement on the indemnitee to prove it is an additional insured under the policy than merely the fact the indemnitor was on the job site or had some connections with the loss.

The second narrowing of the Additional Insured status seen in the 2004 editions of the Additional Insured forms is the elimination of coverage when the Additional Insured is solely at fault for the loss. The forms create this "exclusion" by stating that the bodily injury, property damage, or personal injury and advertising injury must, "in whole or in part," be caused by the indemnitor's acts

or omissions, or those acting on the indemnitor's behalf, in the performance of the indemnitor's ongoing operations at the scheduled locations. See e.g., ISO form CG 20 10 07 04. In other words, even if the indemnitee bargained for Additional Insured status under the indemnitor's CGL policy, and the agreement passes muster under the jurisdiction's statutes and caselaw, the indemnitee will not have coverage under the indemnitor's policy if the indemnitee is solely at fault for the loss at issue.

In light of these recent changes, the party seeking Additional Insured status should seek, to the extent commercially available, to have the indemnitor require its insurance carrier to utilize the pre-July 2004 editions of the Additional Insured endorsements when adding the indemnitee as the Additional Insured. An example of this language is as follows:

*“[Indemnitor] agrees to provide the [Indemnitee] with the Additional Insured status called for under this agreement pursuant to ISO form CG 24 10 11 85 or equivalent language.”*

The indemnitee should carefully review the Additional Insured endorsement which will be added to the indemnitor's policy to be sure the form is properly filled out with the requisite information needed to make the Additional Insured status effective.

**Products/Completed Operations Considerations:** Completed Operations Exposures: A key element of insurance is protection, not only from ongoing activities or day-to-day operations, but from risks associated with manufactured products and injuries associated with previously completed projects. When these risks are involved, the parties should address whether the Additional Insured status extends to “products” and “completed operations” exposures.

When the ISO Additional Insured endorsement form CG 20 10 debuted in 1985, the Additional Insured received coverage with respect to “liability arising out of ‘your work’ performed for that insured by or for you.” ISO form CG 20 10 11 85. “Your work” was and is generally defined as the work or operations performed by the indemnitor for the indemnitee. In other words, this early form not only provided Additional Insured status for the indemnitee with regard to the indemnitor’s ongoing operations involved with the business transaction, but also provided the indemnitee with Additional Insured status for liabilities related to the indemnitor’s work once the work was put to use. This “completed operations” coverage was valuable additional protection for the indemnitee in case injury or damage arose after the work was completed.

The insurance industry did not believe it should be covering Additional Insureds for its Named Insured’s completed operations. Therefore, ISO modified the Additional Insured endorsement form CG 20 10 in its October 1993 edition to only convey Additional Insured status to “liability arising out of your *ongoing operations* performed for that insured.” ISO form CG 20 10 10 93.<sup>14</sup> Despite the intent to eliminate “completed operations” coverage, many Additional Insureds persisted in arguing that the broad “arising out of” wording, in conjunction with the phrase “ongoing operations,” continued to provide completed operations coverage to the Additional Insured once the project was completed as the injury would not have occurred “but for” the indemnitor’s operations.

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<sup>14</sup> There are modified versions of the November 1985 (“11 85”) editions of the ISO Additional Insured forms which also contain this “ongoing operations” language. Therefore, an indemnitee should carefully review the indemnitor’s Additional Insured form language, even if the indemnitor claims it is utilizing ISO form CG 20 10 11 85 in its policy so the indemnitee can determine whether the term “work” or “ongoing operations” is utilized in the form.

To eliminate this possible ambiguity, ISO again modified the Additional Insured form CG 20 10 in 2001 by adding an explicit “completed operations” exclusion to the coverage:

“There is no coverage for injury or damage that occurs:

after all the work for the Additional Insured has been completed, or

after the portion of the work out of which the injury or damage occurs has been put to its intended use.”

ISO Form CG 20 10 10 01. This revision put to rest attempts to seek Additional Insured status with regard to these endorsements for “completed operations.”

If the business transaction implicates risks associated with projects after they are completed (such as in construction scenarios), the indemnitee should seek to have its Additional Insured status memorialized on an endorsement such as ISO form 20 10 11 85 which utilizes “arising out of” and “your work” language to be eligible for CGL coverage which is as broad as possible. An example of language which reflects this intent is set forth in the immediately preceding section.

There is one word of caution as to completed operations exposures, however. It is increasingly difficult to obtain an Additional Insured status with the use of form CG 20 10 11 85. Moreover, additional forms introduced to extend completed operations to certain Additional Insureds such as owners, lessees, or contractors, contain limitations which bar coverage if the Additional Insured is solely at fault for the liability at issue. See, e.g., ISO form CG 20 37 07 04 (completed operations coverage for Additional Insureds restricted to matters “caused by” the liability, in whole or in part, by the indemnitor, thereby exempting coverage for the Additional Insured if it is solely at

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fault for the liability at issue). Therefore, it is critical that, if completed operations exposures are at issue, the parties address how these exposures will be handled.

Products Exposures: If the exposures at issue involve products situations, the parties may wish to consider how the party downstream from the manufacturer or distributor will be insured for losses which might arise due to product liability claims. In these cases, ISO has developed an “Additional Insured – Vendors” endorsement, form 20 15. This scheduled form provides product liability coverage for distributors or sellers of the manufacturer’s products, but only as to the scheduled vendor, the scheduled product(s), and if the Additional Insured has not been involved with one of several acts which would invoke one of the endorsement’s numerous exclusions. The distributor or seller would need to look to its own coverages if the losses fall outside of these specific areas of protection.

The vendor’s endorsement utilizes “arising out of” language in defining who is an insured:

“A. Section II – Who Is An Insured is amended to include as an additional insured any person(s) or organization(s) (referred to below as vendor) shown in the Schedule, but only with respect to "bodily injury" or "property damage" arising out of "your products" shown in the Schedule which are distributed or sold in the regular course of the vendor's business, . . . .”

Issues have arisen as to what the scope of the additional insured protection is for a distributor under such an endorsement. It seems the scope of coverage should be limited to products liability-related exposures, and this is how at least one court has recently interpreted the language. Raymond Corporation v. National Union Fire Ins. Co., 5 N.Y.3d 157, 833 N.E.2d 232, 800 N.Y.S.2d 89 (2005). However, older decisions have interpreted this language expansively to provide a vendor

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with coverage for the vendor's sole liability incurred in the sale of the product. See e.g., The Pep Boys v. Cigna Indemn. Ins. Co., 692 A.2d 546 (N.J. Super. App. Div. 1997) (liability allegedly arose out of negligence in the sale of Freon to a minor); Sportmart, Inc. v. Daisy Mfg. Co., 645 N.E.2d 360 (Ill. App. 1994) (negligence asserted against vendor for selling BB gun pellets). These courts determined that the endorsement does not limit its protection to merely products liability-related claims, and therefore any injury "arising out of" the product is covered.

As with the Insured Contract and other Additional Insured endorsements discussed above, ISO attempted to limit the coverage provided by form 20 15 in its 07 04 Edition by eliminating vendor protection for liability which is related solely to the vendor. This was accomplished by adding an exclusion to the endorsement which bars coverage if the bodily injury or property damages "arises out of" the sole negligence of the vendor (subject to a few exceptions). It is curious ISO would retain the "arising out of language" in this endorsement when it effectively narrowed the causal requirement in the Additional Insured and Insured Contract forms amended by the 07 04 Editions with "caused by" language. Nonetheless, it is clear the vendor has greater coverage available to it under the pre-07-04 Editions than under the 07 04 Edition.

If the parties intend that the manufacturer or other "upstream" party in the chain of the product's distribution is to only provide product liability insurance for the product, the parties may wish to consider use of the following language to confirm this intent:

***"The [Indemnitee's] Additional Insured status provided for in this Agreement shall include such status pursuant to ISO endorsement CG 20 15 07 04."***

There is no assurance that the 07 04 Edition of form 20 15 will never apply to cover a vendor's non-products liability-related risks; however, under the 07 04 Edition, the endorsement's coverage will likely not extend coverage when the sole liability at issue is the vendor's.

**Employee Injury Exclusion and Cross-Liability Exclusion:** There are additional policy exclusions or provisions which could impact the scope of coverage available to the indemnitee despite the fact it is named as an Additional Insured under the indemnitor's policy. The two exclusions discussed here should be removed from the indemnitor's policy if the indemnitee is seeking expansive coverage. Additionally, the parties should specifically examine the indemnitor's policy to determine if either of the following provisions, either alone or in connection with other provisions, may defeat Additional Insured coverage for the indemnitee if an issue arises after a loss.

Employee-Injury Exclusion: An Employee-Injury Exclusion bars coverage for "bodily injury sustained by *any* employee of *an* insured in the course of employment for that insured" (emphasis added). This exclusion underscores just how subtle the use of words can be in a contract. Note the exclusion utilizes the term "an." Since the indemnitee seeks Additional Insured status, it is "an" insured for the purposes of this exclusion. Therefore, this exclusion would bar coverage for the indemnitee under the indemnitor's policy for claims brought by its employees. However, the exclusion has a broader impact than to just bar coverage for the indemnitee's employee's claims against the indemnitee. The exclusion also bars coverage for any claim *the indemnitor's* employee may bring against the indemnitee so long as the loss was sustained in the course of the employment for the indemnitor. See, e.g., Erdo v. Torcon Constr. Co., 645 A.2d 806, 809-10 (N.J. Super.

1994).<sup>15</sup> This is because coverage is barred when *any* employee of *an* insured brings the claim against *an* insured.

The broad application of an Employee-Injury Exclusion may be mitigated somewhat by the inclusion of a Severability Clause in the policy. A Severability Clause ensures that the insurance policy applies separately to each insured. Erdo, 645 A.2d at 809-10. See also, American Nat'l Fire Ins. Co. v. Estate of Fournelle, 472 N.W.2d 292 (Minn. 1991) (explaining that intent of severability clause is to provide each insured with separate and distinct coverage; existence of severability clause demands that policy exclusions be construed with reference to particular insured seeking coverage); Cook v. Country Mut. Ins. Co., 466 N.E.2d 587 (Ill. App. 1984) (auto policy applies separately to each insured against whom a claim or lawsuit is filed). Therefore, if the policy insures both the Indemnitor and indemnitee, the policy is to be read separately as to each of the insureds.

A Severability Clause in a policy with an Employee-Injury Exclusion can change the coverage determination when the claim is one brought by the indemnitor's employee against the indemnitee. Since the Severability Clause requires insureds to be treated separately, a claim brought by the indemnitor's employee against the indemnitee may no longer be barred by that exclusion. See, e.g., Erdo, 645 A.2d at 809-10. The rationale employed is that, if the policy is applied separately to each insured, the indemnitor's employee suit against the indemnitee is not one brought by the indemnitee's

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<sup>15</sup> This result may change if the indemnitor's policy also contains a Severability Clause. See following discussion.



employee. Id. However, again, this is a state law issue, and the applicable state statutes and caselaw should be consulted to see if this is the rule in the jurisdiction.

Cross-Liability Exclusion: An additional exclusion, however, may even trump the Severability Clause's effect on an Employee Injury Exclusion. A Cross-Liability Exclusion bars coverage for "any liability for bodily injury or personal injury caused by an employee of one Insured to an employee of another Insured." BP Chemicals, Inc. v. First State Ins. Co., 226 F.3d 420, 428-29 (6th Cir. 2000). In other words, this exclusion eliminates coverage for suits brought by one insured's employee for injuries and damages caused by another insured's employee. Moreover, given that the language of this exclusion actually contemplates more than one insured in its application of the language, it is likely impossible to argue that a Severability Clause renders this exclusion inapplicable if the indemnitor's employee sues the indemnitee.

**Severability of the Parties' Interests in the Policy:** Most liability insurance policies already contain provisions which mandate that the carrier's obligations under the policy, but for the amount of coverage available, apply separately to each entity insured under the policy. However, the parties should not necessarily assume that all policies always includes this severability of interests language. In order to make sure that the Additional Insured is provided with as broad of a set of rights available under the policy as the Named Insured, the parties should consider adding the following language to the agreement:

*"The [Indemnitor] agrees the insurance provided to [Indemnitee] as an Additional Insured shall provide for the severability of the various insureds' interests."*

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**Primary Coverage:** By adding the indemnitee as an Additional Insured to the indemnitor's policy, it is likely the indemnitee will be covered for a liability loss related to the transaction under both its own CGL policy and the policy where it is named as an Additional Insured. Since the parties likely contemplate that the indemnitor's policy is intended to be the coverage applicable to such losses, the parties should be sure this intent is effectuated.

At times, a carrier may validly claim that its coverage for the Additional Insured is not first in line to respond with a defense, or with settlement or judgment monies. In those situations, carriers may end up delaying payment of defense expenses in an effort to force other carriers to initially respond. Clearly, this type of "brinkmanship" between carriers does not benefit the Additional Insured indemnitee. Therefore, in order to avoid these types of inter-carrier disputes, the indemnitee may wish to consider including a clause in the Agreement which compels the Additional Insured coverage under the indemnitor's CGL policy to be "primary and noncontributing" so that the CGL carrier must respond to a valid tender of defense and request for indemnity. Language which would impose such an obligation on the indemnitee is as follows:

*"Such insurance afforded to the [Indemnitee] as 'Additional Insured' under the [Indemnitor's] policies shall be primary insurance and not excess over, or contributing with, any insurance purchased or maintained by [Indemnitee]."*

This request will likely require the policy to be endorsed to change or eliminate its "Other Insurance" clauses to reflect this primary and noncontributing status.

If a party has not included this clause in the Agreement, it will need to analyze the various policies' "Other Insurance" clauses to determine if these clauses can be harmoniously read together

to rank the policies as primary (or co-primary), secondary, tertiary, and so on. There are a variety of types of “Other Insurance” Clauses:

- “Primary:” These clauses mandate that the coverages afforded are the first to respond to a loss;
- “Pro-Rata:” These clauses seek to coordinate their coverage with other “primary” coverages so both policies respond jointly to the loss. These clauses may mandate that coverage limits are provided “by shares,” or “by limits;”
- “Excess:” These clauses seek to have their coverage respond after at least one primary policy has exhausted its limits;
- “Escape:” These clauses, rarely utilized today, seek to avoid any coverage obligations whatsoever so long as some other policy responds to the loss.

If these clauses can be applied without conflict, they should be so enforced. However, if there is a conflict in these clauses, then the issue of which policy responds first is determined by an analysis of the applicable state law rules governing Other Insurance clause interpretations. These rules vary from state to state, and the particular applicable state rule should be analyzed to answer this question.

The standard ISO coverage forms CG 10 01 and 10 02 now include a provision in its “Other Insurance” clauses which state that:

“This insurance is excess over:

\* \* \*

- “(2) Any other primary insurance available to you covering liability for damages arising out of the premises or operations for which you have been added as an additional insured by attachment of an endorsement.”

In other words, if the indemnitor's policy follows standard ISO language, its policy will be considered excess over the coverage available under the policy where it is identified as an Additional Insured so long as the Additional Insured status is pursuant to an endorsement. This is the principal reason why the Additional Insured status must be added by endorsement.<sup>16</sup>

However, in order to confirm the parties' intent that the indemnitor's policy will carry the fortuitous risks involved with the business transaction, the following language should be considered:

*“The insurance under which [Indemnitee] is identified as an Additional Insured shall be primary and noncontributing insurance and not excess over any insurance purchased or maintained by [Indemnitee].”*

**Policy Deductibles:** Parties often employ a deductible or self-insured retention (“SIR”) feature in their policies in order to better manage their risk protection dollars. This feature is frequently overlooked in allocating risks in Additional Insured situations. The parties should address which party will be obligated to pay the deductible or SIR if a claim is made where the Additional Insured status activates the applicable insurance.

Standard ISO CGL policy forms do not contain provisions for SIRs or deductibles, but these features can be added to the policy by endorsement. A typical ISO form providing for deductibles is CG 03 00 01 96, the “Deductible Liability Insurance” Endorsement. This form allows the policyholder to determine the amount of the deductible to apply for bodily injury, property damage,

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<sup>16</sup> In Vendor situations, the downstream party will need to have its own policy amended with language based on ISO form 24 10 07 98 which is entitled “Excess Provision – Vendors.” This endorsement confirms that the downstream party's coverage will be excess over the upstream party's insurance in situations where the Vendor's Endorsement (CG 20 15) discussed above is utilized.

or for a combined deductible for both types of liability. The selection can be made on a “per-claim” basis, or a “per-occurrence” basis.

Under this form, the obligation to pay the deductible falls on the Named Insured under the endorsement’s Part D:

“We may pay any part or all of the deductible amount to effect settlement of any claim or ‘suit’ and, *upon notification of the action taken, you shall promptly reimburse us for such part of the deductible amount as had been paid by us.*”

Id. “You” is defined in the standard ISO CGL form as “the Named Insured shown in the declarations, and any other person or organization qualifying as a Named Insured under this policy.” See e.g., CG 00 01 10 01 at p. 1. In other words, if an indemnitee is added as an “Additional Insured” under an indemnitor’s policy containing this form, the indemnitor as Named Insured is required to pay the deductible. Moreover, if the carrier pays the deductible amount, its only recourse is to collect the deductible amount from the Named Insured and not from the Additional Insured.

If the indemnitor’s policy contains a deductible provision utilizing ISO form CG 03 00 01 96, and the parties intend the indemnitor to also pay the deductible, then a specific provision in the business transaction need not be included. However, since standard Certificates of Insurance usually do not highlight whether or not a deductible feature is part of a policy, and since the transaction negotiation may be delayed to investigate this issue, it is best to include a provision in the Agreement which allocates the risk of which party is to pay the deductible or SIR amount if one exists in the indemnitor’s policy:

*“The parties agree that, if the commercial general or other liability policy under which [Indemnitee] is added as an Additional Insured contains provisions for*

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*payment of any deductible, self-insured retention or similar feature, and if such insurance is called upon to insure [Indemnitee] under any circumstances, [Indemnitor] shall be obligated to promptly pay any amount of deductible, self-insured retention or similar feature which is mandated under the commercial general or other liability insurance in accordance with the insurance's provisions."*

Of note, this provision will require the indemnitor to pay the deductible or SIR for any type of coverage, not just the bodily injury or property damage coverage contemplated under form CG 03 00.

**Waiver of Subrogation:** An insurer generally has a right to seek recovery for any amounts paid under the policy from those who are ultimately responsible for the loss. In addition to an insurer's common law right of subrogation, typical CGL policies contain a "Transfer of Rights of Recovery Against Others to Us" clause in the Conditions section of the policy. That condition states:

"If the insured has rights to recover all or part of any payment we have made under this Coverage Part, those rights are transferred to us. The insured must do nothing after the loss to impair them. At our request, the insured will bring 'suit' or transfer those rights to us and help us enforce them."

See e.g., CG 00 01 10 01 at p. 12. This language underscores the concept that an insurer has obligations which attach at the time of the incident under which coverage is sought; however, it also has certain rights which attach at that time as well. Therefore, an insured cannot do anything *after the loss* to impair the carrier's subrogation rights. Since this is a temporal obligation (*after the loss*), the policy provision implicitly recognizes that an insured may compromise the carrier's subrogation or transfer rights *before* the loss.

The insurance industry recognizes this type of waiver has a legitimate business purpose. The parties to the business transaction may want to assure finality to any legal dispute, and to not be subjected to an additional round of litigation which subrogation actions sometimes involve.

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Therefore, ISO provides an endorsement which can effectuate this intent: form CG 24 04 10 93. This form is a scheduled endorsement which requires the indemnitee's identification in order to waive the transfer rights. However, a blanket "scheduling" on this endorsement with the following language may suffice:

"Any person or organization to whom the Named Insured is obligated by contract or agreement to provide a waiver of subrogation or recovery."

Id. The waiver under this endorsement not only applies to a loss arising out of the indemnitor's operations or activities while they are being performed, but also applies to the indemnitor's completed operations.

In order to confirm that the indemnitor's carrier will waive its subrogation rights, the parties may wish to consider adding the following language to the Additional Insured section of an agreement:

*"[Indemnitor] agrees to endorse its commercial general or other liability insurance under which [Indemnitee] is added as an Additional Insured with a Waiver of Subrogation endorsement consistent with the language of ISO form CG 24 04 10 93 and identifying [Indemnitee] on the form's schedule."*

**Notice of Any Change in the Policy's Existence:** In order for the Additional Insured to gain access to the coverage, the policy must be in effect as of the critical date which would trigger the protection. There are numerous reasons why a policy could be cancelled, changed, or even expire without the Additional Insured ever knowing of this change. Since the parties allocated the business transaction's risks in part based on the existence of the policy when needed, the Additional Insured has a keen interest in knowing if the policy taking on that risk will not be available to respond to the

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loss. Therefore, the Additional Insured needs to include in the Agreement some provision which will allow it to receive notice of any change in circumstances in the policy's existence.

One approach is to mandate that the policy cannot be altered or terminated without giving "adequate" notice to the Additional Insured. The parties should determine what constitutes "adequate" notice depending on the nature of the circumstances, and also consider alternatives if the coverage contemplated would not be available. The former should be discussed as part of the initial transaction; the latter can wait until the notice is provided if the parties choose to address this issue in this fashion. Also, the parties may consider whether or not notice should be provided with regard to any change in the existence of the other party's insurance.

The following is an example of possible language to consider as part of the insurance provisions of the contract.

*"[Indemnitor] agrees that the insurance it is obligated to procure and maintain under this Agreement shall require the insurer providing such coverage to give at least 60 days notice to [Indemnitee] that the policies are being amended, altered, modified, canceled or are expiring by providing such notice via registered mail to the [Indemnitee] in care of the following:*

*[INDEMNITEE CONTACT PERSON AND POSITION]  
[ADDRESS].*

*However, if the cancellation of the insurance is because of the nonpayment of premium, [Indemnitor] agrees that the insurance it is obligated to procure and maintain under this Agreement shall require the insurer providing such coverage to give at least 10 days notice to [Indemnitee] that the policies are being canceled*



*because of nonpayment of premium by providing such notice via registered mail to the [Indemnitee] at the contact identified in this paragraph.*<sup>17</sup>

**How Long Should the Indemnitee Be Named as an Additional Insured?** The parties may believe they are permanently allocating risks when the Agreement includes a provision which states one party will become an Additional Insured under the other's policy. The "permanence" of this coverage is not necessarily an issue if the risks addressed are ongoing activities or operations which would necessarily cease at the conclusion of the business transaction.

This is not the case, however, when "products" and "completed operations" exposures are involved. As referenced above, these exposures give rise to the possibility that bodily injury and/or property damage could happen over several years after the product is shipped, or after the work performed for one of the parties has been completed. The parties will need to address how to allocate these risks, and Additional Insured concepts can assist in doing so.

As noted above, all business transactions eventually expire, either because the agreement's term ends or because its obligations are fulfilled. At what point, if at all, does the obligation to be identified as an Additional Insured end? The parties should not put themselves into a situation where they have a disagreement on this point years down the line.

The issue is muddled by the point CGL coverage can be written on an occurrence or claims-made basis. If the indemnitor's policy is written on a claims-made basis, the indemnitee is forever

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<sup>17</sup> The second paragraph of this language addresses situations where the policy might lapse due to nonpayment of premium. The ten day notice provision for this situation brings this obligation in line with numerous state laws which only require a carrier to provide ten days notice in these situations.

barred from accessing Additional Insured coverage when the policy expires. If the indemnitor's policy is written on an occurrence basis, the indemnitee may be able to access Additional Insured coverage in future years so long as other conditions of the policy are met. However, in both events, the indemnitee will never be able to access Additional Insured coverage if it is not named as an Additional Insured under the indemnitor's *subsequent years'* CGL policies.

It seems to be commercially unreasonable to mandate that one party name another as an Additional Insured indefinitely into the future. Therefore, the parties need to discuss whether the party seeking the Additional Insured status requires the status for any reason after the time all other obligations under the agreement have been fulfilled, and, if so, how long should the indemnitor also name the indemnitee as an Additional Insured.

The parties may wish to consider the following language to memorialize their understandings:

***“The parties agree the duty to identify [Indemnitee] as an additional insured as set forth in this Agreement shall survive the expiration or termination of this Agreement for a period of \_\_\_\_\_ years.”***

Of note, unlike the discussion on insuring the agreement's indemnification obligation, a “sunset” provision is utilized here. At this point, standard ISO policy language automatically covers liability assumed under an indemnification agreement, at least to the extent where both the indemnitor and indemnitee face exposure for the underlying liability. Therefore, until this “insured contract” coverage is no longer commercially available at a reasonable premium, it seems “fair” to require the enforcement of the indemnification obligation and the duty to insure the indemnification obligation indefinitely into the future.

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The Additional Insured status, however, is never “automatic.” The Additional Insured status is created by providing specific directions to the insurer at the time the status begins, as well as at the time the CGL policies are renewed. Because the status does not just “happen” as with “insured contract” coverage, it would seem that putting an endpoint to the ongoing affirmative obligation should end at some point. This is true regardless of whether the parties are engaged in just one transaction, or have an ongoing business relationship.

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**CONFIRMATION OF THE RISK  
MANAGEMENT ALLOCATION IMPLEMENTATION**

An indemnitee has a breach of contract claim against the indemnitor if the indemnitor fails to fulfill any of these obligations to the indemnitee’s detriment. Unfortunately, a breach of contract claim which only involves failure to carry out the structure of the parties’ risk management allocation is likely not covered by the indemnitor’s CGL policy. If the indemnitor is otherwise viable, the indemnitee’s remedy would be to collect any judgment because of this risk management allocation failure directly from the indemnitor itself.

Given that some indemnitors cannot afford to pay a judgment on a large exposure created by a breach of these types of provisions, it is a better practice to be sure the indemnitor has complied with its various obligations. The best approach to confirm that all conditions have been complied with is to obtain a copy of the indemnitor’s CGL policy as amended, and, if need be, coordinate with

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the indemnitor's insurance broker or carrier to implement each and every one of the contractual clauses discussed above. In order to allow the indemnitor to obtain a copy of the indemnitee's policy, the parties may wish to utilize the language suggested above with regard to disclosure of policies to the parties.

Admittedly, this approach is different than the typical confirmation of coverage usually contemplated by the parties: a Certificate of Insurance. Despite their widespread use, Certificates of Insurance are simply not insurance, and provide no confirmation that *all* the contemplated risk management intentions are implemented in the applicable policy. Therefore, in order to give the party seeking protection under the other's policy for either "Insured Contract" coverage for the indemnification agreement and/or the various insurance provisions, it is preferable to obtain a full copy of the applicable insurance policies. Only in this way can the indemnitee confirm that the risk management allocation contemplated by the business transaction is properly implemented.

Once the indemnitee has obtained a copy of the applicable policies, the indemnitee should confirm the policies's language:

- includes the coverage limits as agreed upon;
- provides Insured Contract coverage to protect the indemnification obligation;
- includes the endorsements contemplated by the agreement; and
- includes fully completed schedules in the applicable endorsements added because of the business transaction;

\* \* \* \* \*

## CONCLUSION

These materials provide parties to business transactions with a nonexhaustive set of considerations to weigh when seeking to contractually allocate the third party liability risks which arise under the Agreement through effective use of risk management clauses. If these risk management tools are effectively utilized, the parties will have a significantly greater chance of confirming that their risk transfer intents are fulfilled when issues arise down the line.

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