Mealey's Additional Insured Conference

Who's First in Line? Indemnity Provisions and Contractual Liability Coverage in "Other Insurance" Clauses

By Rachel S. Kronowitz[*]
and John C. Ford[**]

A. Indemnity provisions vs. insurance procurement clauses

Background: Businesses regularly enter contracts in which one party agrees to provide the other with two types of protection against financial risk: (i) an agreement to indemnify the other party for any liability arising out of the first party's activities; and (ii) an agreement to procure a liability insurance policy (or policies) on which the other party is named as an additional insured. These indemnity and insurance-procurement obligations may be most common to construction contracts—in which a subcontractor typically provides protection to the general contractor—but they may also appear in all manner of business agreements, including joint ventures, mergers, or other corporate undertakings.

Some states, however, have passed statutes or have common law rules that prohibit certain agreements of the first type noted above—namely, those in which a party agrees to indemnify liability that results entirely or in part from the negligence of the indemnitee.

For example, Delaware's typical "anti-indemnity" statute states that a promise in a construction contract:

> purporting to indemnify or hold harmless the promise . . . for damages arising from liability for bodily injury or death to persons or damages to property caused partially or solely by . . . negligence of such promise . . . is against public policy and is void and unenforceable.

6 Del. Code § 2704(a).

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Thus, in some cases the indemnity obligation will be voided by state law.

Where this is the case, the indemnitee will likely look to the insurance policy on which it has been named as an additional insured—the second type of agreement mentioned above—as a vehicle for recovering any losses. In these situations, the insurer may respond that it has no obligation to provide coverage. The insurers' theory may be:

- The insurer has no obligation because its coverage was co-extensive with the contractor's (invalidated) duty to indemnity;
- The insurance coverage is a type of indemnity prohibited by the state law;
- The insurance coverage, while not explicitly prohibited by the statute, is an impermissible "end run" around its intent.

The insurer's argument may take many different forms, depending on the specific facts and applicable law. The first argument mentioned above, however, is the type most frequently asserted.

The Issue: Where the law voids an indemnification obligation in a contract that also called for the procurement of insurance on behalf of the indemnitee, is the insurer's coverage to the indemnitee also invalidated?

Overview: This is not a settled issue, and its resolution in any particular case depends greatly on the wording of the applicable indemnity agreement, policies, and state laws. Most courts to address the question, however, have found the insurance obligation to be separable from an invalidated indemnity obligation, and have required the insurer to provide coverage.

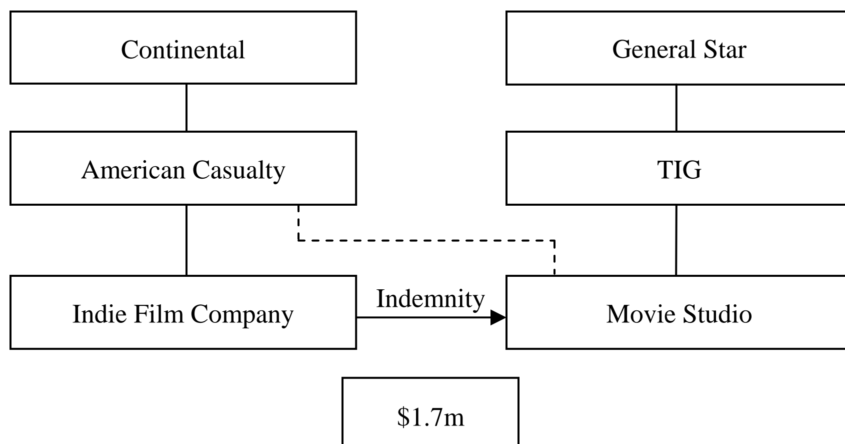
In a number of cases reaching this result, the relevant state law explicitly states that it does not affect insurance obligations. The Delaware statute, for instance, states that "nothing in subsection (a) of this section shall be construed to void or render unenforceable policies of insurance issued by duly authorized insurance companies and insuring against losses or damages from any causes whatsoever." 6 Del. Code § 2704(b).

American Casualty Co. v. General Star Indemnity Co., 125 Cal. App. 4th 1510, 24 Cal. Rep. 3d 34 (2005), presents a common fact

pattern. In that case, an independent film company leased a back lot from a movie studio. Under the lease, the film company agreed to indemnify the studio for all liability arising from the lease arrangement, to obtain insurance for liability arising out of the use of the back lot, and to make the studio an additional insured on its policies. The film company obtained both primary and excess insurance policies in satisfaction of its obligations. Separately, the movie studio maintained its own primary and excess insurance.

During the lease, the studio maintained high tension wires strung across the back lot. Due to this dangerous condition—arguably, the sole fault of the studio—an employee of the film company was injured while constructing sets. The injury resulted in a $1.7 million judgment against the studio.

The relationship among the parties looks like this:



A California statute prohibited agreements to "indemnify the promisee against liability for" any loss "arising from the sole negligence of the promisee," Cal. Civil Code § 2782. Thus, if the injury was due solely to the studio's fault, the film company's indemnity obligation was void under California law.

Based on the anti-indemnity statute, the film company's primary carrier, American Casualty, brought an action against the studio's excess carrier, General Star. American Casualty argued that because the film company had no liability to the studio pursuant to the indemnification agreement, American Casualty had no liability under its additional insured endorsement.

The California court of appeals disagreed, and found the insurance policy to be a separate contract that was not contingent on the

validity of the lease's indemnification agreement. The court found additional support in the statute invalidating the indemnification agreement, which specially states that it "shall not affect the validity of any insurance contract." Cal. Civil Code § 2782.

In Depth: 1) *Landscape of anti-indemnity statutes*

The anti-indemnification statutes, of course, differ in their particulars. Most of those discussed here limit their scope to construction-related contracts, although statutes exist that apply to indemnity agreements in other specific industries as well. *See* Rick L. Rambo, "Admiralty Law," 30 Tex. Tech. L. Rev. 363, 389-95 (1999) (discussing Louisiana Oilfield Immunity Act and Texas Oilfield Immunity Act).

The construction-related acts can be broken into two broad categories:

- At least eighteen state statutes bar indemnification for the indemnitee's sole negligence:
    - Alaska (Alaska Stat. § 45.45.900)
    - Arizona (Ariz. Rev. Stat. § 32-1159)
    - California (Cal. Civ. Code § 2782)
    - Georgia (Ga. Code Ann. § 13-8-2)
    - Hawaii (Haw. Rev. Stat. § 431:10-222)
    - Idaho (Idaho Code § 29-114)
    - Indiana (Ind. Code Ann. § 26-2-5-1)
    - Maryland (Md. Code. Ann. Cts. Jud. Proc. § 5-401)
    - Michigan (Mich. Comp. Laws Ann. § 691.991)
    - New Jersey (N.J. Stat. Ann. § 2A:40A-1)
    - Oregon (Or. Rev. Stat. § 30.140)
    - South Carolina (S.C. Code Ann. § 32-2-10)
    - South Dakota (S.D. Codified Laws § 56-3-18)
    - Tennessee (Tenn. Code ann. § 62-6-123)
    - Utah (Utah Code Ann. § 13-8-1)
    - Virginia (Va. Code Ann. § 11-4.1)
    - Washington (Wash. Rev. Code § 4.24.115)
    - West Virginia (W. Va. Code § 55-8-14)

- o At least sixteen state statutes bar indemnification for the indemnitee's negligence, even if only partial:

    - Arizona (Ariz. Rev. Stat. § 34-226 (local governments); Ariz. Rev. Stat. § 41-2586 (state government)
    - Colorado (Colo. Rev. Stat. § 13-50.5-102(8) (public entities))
    - Connecticut (Conn. Gen Stat. § 52-572K)
    - Delaware (Del. Code Ann. Tit. 6 § 2704)
    - Florida (Fla. Stat. Ann § 725.06)
    - Illinois (740 Ill. Comp. Stat. 35/1)
    - Louisiana (La. Rev. Stat. Ann. § 38:2216(G) (public projects))
    - Massachusetts (Mass. Gen. Laws Ann. Ch. 149 § 29C)
    - Minnesota (Minn. Stat. Ann. § 337.02)
    - Mississippi (Miss. Code ann. § 31-5-41)
    - Missouri (Mo. Ann. Stat. § 434.100)
    - Nebraska (Neb. Rev. Stat. Ann. § 25-21, 187(1))
    - New Mexico (N.M. Stat. Ann. § 56-7-1)
    - New York (N.Y. Gen. Oblig. Law § 5-322.1)
    - North Carolina (N.C. Gen. Sat. § 22B-1)
    - Ohio (Ohio Rev. Code Ann. § 2305.31)
    - Rhode Island ®.I. Gen. Laws § 6-34-1)

See Allen Hot Gwyn and Paul E. Davis, "Fifty-State Survey of Anti-Indemnity Statutes and Related Case Law," 23 Construction Lawyer 26 (Summer 2003)

The statutes also differ in the extent to which they address insurance:

- o Many of the statutes are silent on the extent to which they effect insurance;
- o Others explicitly state that they do not apply to any insurance-procurement agreements or insurance policies (*e.g.,* Delaware, Illinois, Minnesota, Missouri);
- o Only one anti-indemnity statute, Oregon's, expressly voids insurance-procurement obligations. *See Walsh Construction Co. v. Mutual of Enumclaw,* 104 P.3d 1146 (2005) (analyzing O.R.S.

§ 30.140(1), which prohibits "any provision in a construction agreement that requires a person *or that person's surety or insurer* to indemnify another . . .") (emphasis added).

2) *Policy*

There are a number of policy reasons for preserving insurance coverage obtained pursuant to a contract with a voided indemnification agreement. They include the following:

- Insurance is a well-accepted method of risk allocation;
- Insurance procurement agreements do not relieve the promisee of statutory and regulatory consequences of maintaining unsafe conditions (*i.e.,* at a workplace);
- Having insurance in place provides injured workers with a source of compensation.

Courts have also found policy reasons for invalidating insurance coverage. Obtaining insurance as an alternative to indemnity has been seen by some courts as a way of getting around the anti-indemnity statutes—doing something indirectly that one cannot do directly. *See Chrysler Corp. v. Merrell & Garaguso, Inc.*, 796 A.2d 648 (Del. 2002); *Peeples v. Detroit,* 297 N.W.2d 839 (Mich. App. 1985) (discussed below).

2) *Common law rules*

In states that do not have anti-indemnity statutes, indemnity agreements can be invalidated by common law rules. One widely accepted common law rule makes indemnity provisions unenforceable if the requirement to indemnify a negligent indemnitee is not clearly and unequivocally expressed.

The relationship between an indemnity agreement invalidated pursuant to common law and any accompanying insurance obligations has not been extensively explored. The Minnesota courts, however, have declared a rule that "where an indemnity clause is unenforceable under a common law standard, the insurance-procurement clause whose scope is defined by the indemnity provision is also defeated." 24 No. 8 Ins. Litig. Rep. 320 (2002) (citing *Katzner v. Kelleher Construction*, 545 N.W. 2d 378 (Minn. 1996)).

3) *Opposing authority*

The issue discussed here turns on whether the insurer's obligation under the additional insured endorsement is distinct from the indemnity obligation—and, as noted, most courts have found that it is.

- They have done so even when the language of the indemnity agreement colorably limits the coverage to the indemnity obligation. *See Shell Oil Co. v. National Union Fire Ins. Co.,* 44 Cal. App. 4th 1633 (1996) (finding obligations distinct where contract obliged general contractor to acquire "contractual liability coverage *for Contractor's obligations hereunder to defend and/or indemnify Shell*") (emphasis added).
- They have also done so even when the statute invalidating the indemnity obligation does not specifically state that insurance coverage is unaffected. *See Kenney v. G.W. Lisk Co.,* 556 N.E. 2d 1090, 1092 (N.Y. 1990); *c.f. Heat & Power Corp. v. Air Products & Chemicals, Inc.,* 578 A.2d 1202 (Md. 1990) (finding that insurance obligation remained despite invalidation of indemnity obligation, without need to decide whether anti-indemnity statute's exemption for insurance procurement agreements applied).

Other cases have, however, found the insurance coverage to be invalidated along with the indemnity agreement.

- In the contract at issue in *St. Paul Fire & Marine Ins. Co. v. American Dynasty Surplus Lines Inc. Co.*, 101 Cal. App. 4th 1038 (2002), for instance, the indemnity and insurance procurement clauses were located in separate articles of the contract and made no reference to each other. Furthermore, the additional insured endorsement did not reference the contract's indemnity provision. Nonetheless, after finding ambiguity in the additional insured endorsement, the court held that it could not reasonably be interpreted as being broader than the subcontractor's indemnity obligation.

- Similarly, in *BP Chemicals, Inc. v. First State Ins. Co.,* 226 F.3d 420 (6th Cir. 2000), the Sixth Circuit found that insurance coverage obtained for the owner of an electrical systems plant was negated by the invalidity of a contractual promise to indemnify the plant owner. The liability in *BP Chemicals* arose from the negligence of the plant owner. The court based its ruling in large part on the wording of the additional insured endorsement—through which the owner obtained coverage—which stated that it provided coverage "only with respect to liabilities arising out of . . . operations performed by or for the named insured, *but excluding any negligent acts committed by such additional insured [i.e., the plant owner]."* *Id.* at 425 (emphasis added). Although the result appears correct given the working of the endorsement, the analysis in *BP Chemicals* can be read to suggest that an insurance procurement clause is presumptively intended to be co-equal with an indemnity obligation, unless the endorsement states otherwise.

- Another cautionary case is *Chrysler Corp. v. Merrell & Garaguso, Inc.*, 796 A.2d 648 (Del. 2002). The Delaware anti-indemnity statute that applied in *Chrysler Corp.*, as noted above, states that it should not "be construed to void or render unenforceable policies of insurance . . . insuring against losses or damages arising from any causes whatsoever." Despite this language, the Delaware Supreme Court seriously considered an argument that because the statute prohibited an indemnification agreement in a contract for masonry services, it also nullified insurance coverage procured pursuant to that contract. The Delaware Supreme Court sympathized with an argument that the insurance-procurement agreement constituted an "end-run" around the policy behind the anti-indemnity statute. Ultimately, the Court found that the insurance obligation remained, but its misgivings in the face of clear statutory language highlights the possibility of aberrant results for clients facing this issue.

4) *Implications of a finer distinction: between insurance-procurement clauses and insurance coverage.*

Just as there is a distinction between an agreement to provide indemnification and an insurance policy, there is also a distinction between an agreement *to procure* insurance and the insurance policy itself.

As noted, many of the anti-indemnity statutes are silent on insurance-related questions. At least one court has found, however, that a subcontractor's obligation to procure insurance (which covered the general contractor's sole negligence) violated the public policy expressed in the Michigan anti-indemnity statute (*i.e.,* that entities in the construction industry should not be able to enter contracts absolving them from liability for their own negligence), and accordingly voided the obligation to procure insurance. *See Peeples v. Detroit,* 297 N.W.2d 839 (Mich. App. 1985).

This finding, however, does not answer the question of whether insurance actually obtained pursuant to the voided procurement obligation remains in force. When that question later came before the Michigan courts, they enforced the policy. The court "could not see how the question of who should pay the premium, or the public policy surrounding that question, was of any concern to the carrier, especially after the insurer had collected its premium. The carrier's attempt to avoid coverage because the wrong party paid for the policy was without merit." Allen Hot Gwyn and Paul E. Davis, "Fifty-State Survey of Anti-Indemnity Statutes and Related Case Law," 23 Construction Lawyer 26, 28 (Summer 2003) (discussing *Sentry Ins. Co. v. National Steel Corp.*, 382 N.W.2d 753 (Mich. App. 1985)).

Practical: 1) *Policyholders*

- Avoid coupling an indemnity obligation with an insurance-procurement obligation in contracts with business partners. This will increase the likelihood that the insurance coverage will not be voided along with the indemnity clause.
- Verify that your rights and obligations to indemnity are consistent with applicable law.

2) *Insurers*

- Understand that most courts will view the insurance obligation as distinct from the indemnity obligation and structure relationships accordingly.
- To avoid providing coverage in even of voided indemnity obligation, draft additional insured endorsements to explicitly exclude coverage for anything beyond an indemnity obligation.

Authorities: *American Casualty Co. v. General Star Indemnity Co.*, 125 Cal. App. 4th 1510, 24 Cal. Rep. 3d 34 (2005)

Walsh Construction Co. v. Mutual of Enumclaw, 104 P.3d 1146 (2005)

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Shell Oil Co. v. National Union Fire Ins. Co., 44 Cal. App. 4th 1633 (1996)

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Sentry Ins. Co. v. National Steel Corp., 382 N.W.2d 753 (Mich. App. 1985)

Peeples v. Detroit, 297 N.W.2d 839 (Mich. App. 1985)

Zettel v. Pashen Contractors, Inc., 427 N.E.2d 189 (Ill. App. 1981) (holding that duty to make indemnitee additional insured on insurance policy unaffected by anti-indemnity statute)

Stickovich v. Cleveland, 757 N.E.2d 50 (Ohio App. 3d 2001) (same)

Meadow Valley Contractors, Inc. v. Transcontinental Ins. Co., 27 P.3d 594 (Utah App. 2001) (same)

B. Pre-emption of "other insurance" clauses by indemnity provisions

Background: It is not unusual for two or more liability insurance policies to cover the same risk. This occurs, for example, when:

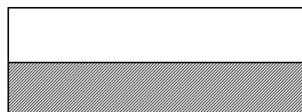
- an entity obtains a primary insurance policy and an excess policy (or policies) covering the identical risk;
- two policyholders are jointly and severally liable for a single judgment (to which no policy exclusions apply); or
- an entity has its liability risk covered by its own insurance policy as well as another insurance policy (*e.g.,* the policy of a business partner) on which it appears as an additional insured.

In the first example, there is no question about the order in which the insurance policies must respond to the covered liability; the primary policy pays first. In many other cases in which two or more policies cover the same risk, however, arguments arise over the order in which the different policies must respond, or, if they are concurrent, what proportion of the total liability the policies cover.

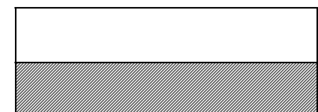
When addressing such disputes, courts turn to the "other insurance" clauses of the policies on the risk. An "other insurance" clause purports to establish the priority and/or proportionate share of responsibility of the policy relative to other policies covering the same risk.

There are three common types of "other insurance" clauses:

- "Pro rata" clauses, which "provide that the insurer will pay its pro rata share of the loss, usually in the proportion which the limits of its policy bear to the aggregate limits of all valid and collectible insurance";

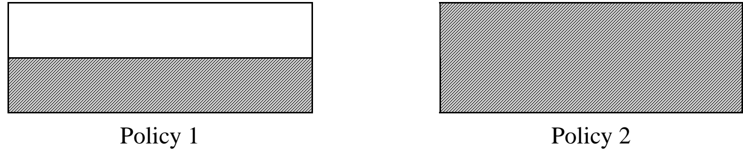


Policy 1

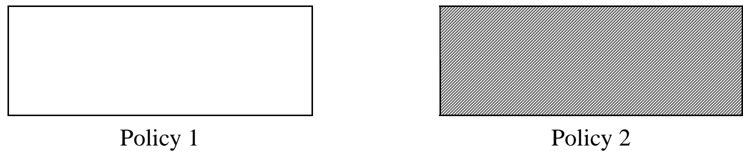


Policy 2

o “Excess” clauses, which “provide that the insurer's liability shall be only the amount by which the loss exceeds the coverage of all other valid and collectible insurance, up to the limits of the excess policy”;



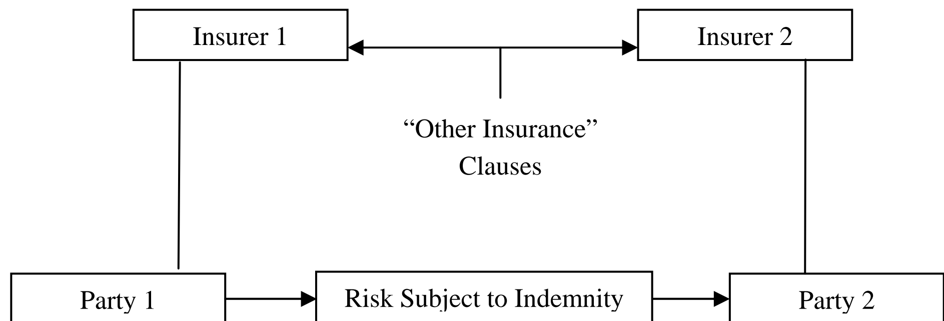
o And “escape” clauses, which “provide that the policy affords no coverage at all when there is other valid and collectible insurance.”



Fireman’s Fund v. Structural Systems Technology, Inc., --- F. Supp. 2d ---, 2006 WL 861296, at *14 (D. Neb. Mar. 28, 2006).

Sometimes, the “other insurance” clauses of the triggered policies will be incompatible—each of them, for instance, may purport to make itself excess to the other(s). In such cases, “courts tend to ‘cancel out’ those conflicting clauses and prorate losses among the insurers on grounds that the insureds would otherwise be unfairly deprived of all their bargained-for insurance protection.” Randall L. Smith and Fred A. Simpson, “Excess Other Insurance Clauses and Contractual Indemnity Agreements Shifting an Entire Loss to a Particular Insurer,” 30 T. Marshall L. Rev. 215, 220 (2004).

Reference to the insurers’ “other insurance” clauses is often the beginning and the end of the allocation question. In some cases, however, the policyholder of one of the insurers (Insurer 1) will have a contractual right of indemnification from a policyholder of another insurer (Insurer 2). The situation can be diagrammed as follows:



In such cases, Insurer 1 likely will make an argument that the entire loss should be borne by Insurer 2, on the basis that its policyholder is not ultimately responsible for any of the loss. Insurer 2, in response, will argue that the insurance policies alone—specifically, their "other insurance" clauses—should determine the allocation question. Any right to indemnification, according to Insurer 2, can be pursued in a separate action by the policyholder with that right, or by Insurer 1 as the policyholder's subrogee.

The Issue: Where multiple insurance policies cover the same risk, can the policyholders' indemnification agreement shift the entire loss to a particular insurer, notwithstanding the fact that a reading of the "other insurance" clauses alone would lead to a different result?

Overview: The clear majority of courts addressing the issue have answered the question in the affirmative. They have determined that indemnity agreements control the allocation question in order to allow the parties involved to get the benefit of their bargain:

> The more recent cases show how courts value and honor the commercial bargaining that took place between the contracting parties. Indemnity agreements are essential part of the total exchange of consideration. . . . [A]ny apportionment of losses pursuant to 'other insurance' clauses in policies would unfairly override and negate indemnity agreements, impose liability on indemnitees' insurers, and ignore the fact that those indemnitees bargained in ways that would avoid such outcomes.

Randall L. Smith and Fred A. Simpson, "Excess Other Insurance Clauses and Contractual Indemnity Agreements Shifting an Entire Loss to a Particular Insurer, 30 T. Marshall L. Rev. 215, 220 (2004).

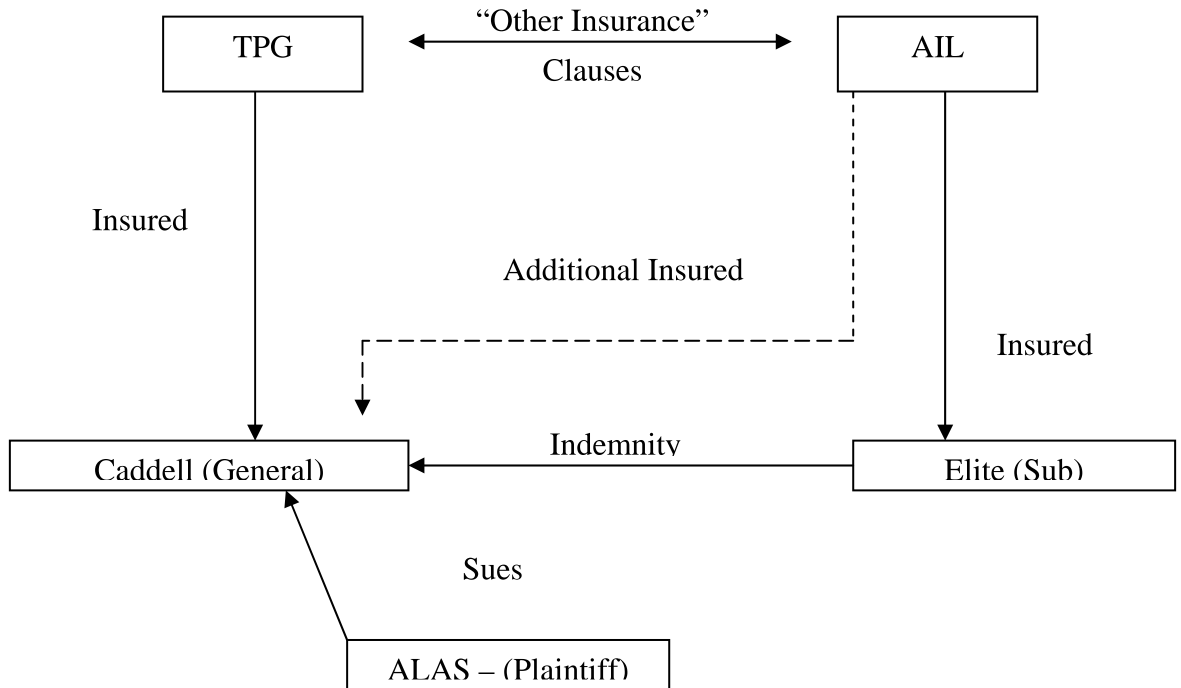
Therefore, "an indemnity agreement between the insured or a contract with an indemnification clause . . . may shift an entire loss to a particular insurer notwithstanding the existence of an 'other insurance' clause in its policy." Lee R. Russ & Thomas F. Segalla, 15 Couch on Insurance § 219:1 (3d ed. 1999)

The case of *American Indem. Lloyd's v. Travelers Prop. & Cas. Ins. Co.*, 335 F.3d 429 (5th Cir. 2003) presents a typical fact pattern. A subcontractor, Elite Masonry, Inc., agreed to perform masonry work for a contractor, Caddell Construction Company,

Inc., on a prison in Texas. The subcontract between Elite and Caddell called for Elite to indemnify Caddell from all liability arising from Elite's performance (unless attributable solely to the fault of Caddell), and to obtain insurance covering itself and Caddell for liabilities arising out of the contract.

Pursuant to the terms of the contract, Elite subscribed to a $1 million policy from American Indemnity Lloyd's (AIL), on which it was a named insured and Caddell was an additional insured. Caddell, separately, had its own $1 million CGL policy (on which Elite was not an insured) from TPG.

During the performance of the contract, an employee of Elite was injured. He originally sued both Elite and Caddell, though at some point the plaintiff nonsuited Elite. The relationship among the parties and the insurers looked like this:



AIL defended the suit and eventually settled it. It then brought suit against TPC, seeking an apportionment of the loss pursuant to the insurers' "other insurance" clauses. TPC claimed that it owed nothing, relying on the indemnity agreement in the Elite-Caddell contract.

The Court agreed with TPC, finding that "the clear majority of jurisdictions . . . gives controlling effect to the indemnity

obligation of one insured to the other insured over 'other insurance' or similar clauses in the policies of the insurers." *Id.* at 436.

The rationale given for the result in *American Indem. Lloyd's* and similar cases is not uniform, though it was most simply—and perhaps most elegantly—put by a federal district court:

> [T]o the extent that Smith Brothers [the indemnitor] is liable to Coho [the indemnitee] for indemnity, so, too, are its insurers, to the extent that their policies provide coverage for Smith Brothers' indemnity liability. To hold otherwise would render the indemnity contract completely ineffectual and would obviously not be a correct result, for *it is the parties' rights and liabilities to each other which determine the insurance coverage; the insurance coverage does not define the parties' rights and liabilities to one another.*

Chubb Ins. Co. v. Mid-Continent Cas. Co., 982 F. Supp. 435 (S.D. Miss. 1997) (emphasis added).

Courts have given other reasons for the majority result, including, most prominently, the desire to avoid circuitous litigation in which subsequent actions by the indemnitee or it's insurer would lead to the same result: the indemnitor's insurer bearing the full liability.

No courts, however, have expressed need to consider indemnity agreements at the allocation stage as any kind of bright line rule. In the words of the Eighth Circuit, "[t]his is not to say . . . that indemnity agreements always govern insurance allocation issues." *Wal-Mart Stores, Inc. v. RLI Ins. Co.,* 292 F.3d 583, 588 (8th Cir. 2002). Instead, the question often turns on the "particular facts of the case, such as the intentions and relationships of the parties." *Id.* at 589.

In Depth: 1) *Concepts: Contribution v. Subrogation*

Courts have said that it is "hard to imagine another set of legal terms with more soporific effect than indemnity, subrogation, contribution, co-obligation, and joint tortfeasorship. It is also difficult to think of two legal concepts that have caused more confusion and headache for both courts and litigants than have contribution and subrogation." *Reliance National Indem. Co. v. General Star Indem. Co.*, 72 Cal. App. 4th 1063, 85 Cal. Rptr. 2d 627 (1999) (quoting *Fireman's Fund Ins. Co. v. Maryland Cas.*

Co., 65 Cal. App. 4th 1279, 1304-07 (1998) (quotations omitted)). In allocation cases, it is important to keep in mind the distinction between these two equitable doctrines:

- **Subrogation:** This is "the substitution of another person in place of the creditor or claimant to whose rights he or she succeeds in relation to the debt or claim. . . . In the case of insurance, subrogation takes the form of an insurer's right to be put in the position of the insured in order to pursue recovery from third parties legally responsible to the insured for a loss which the insurer has both insured and paid. . . . The subrogated insurers is said to 'stand in the shoes' of its insured, because it has no greater rights than the insured and is subject to the same defenses assertable against the insured." *Fireman's Fund,* 65 Cal. App. 4th at 1293-94.

  Note: An insurer seeking recovery from another insurer on the basis of an indemnification agreement will often be relying on a subrogation theory.

- **Contribution:** This is "the right to recover, not from the party *primarily* liable for the loss, but from a *co-obligor who shares* such liability with the party seeking contribution. In the insurance context, the right to contribution arises when several insurers are obligated to indemnify or defend the same loss or claim, and one insurer has paid more than its share of the loss or defended the action without any participation by the others. Where multiple insurance carriers insure the same insured and cover the same risk, each insurer has independent standing to assert a cause of action against its coinsurers for equitable contribution when it has undertaken the defense or indemnification of the common insured." *Id.*

  Note: An insurer seeking recovery from another insurer on the basis of an "other insurance" clause will often be relying on a contribution theory.

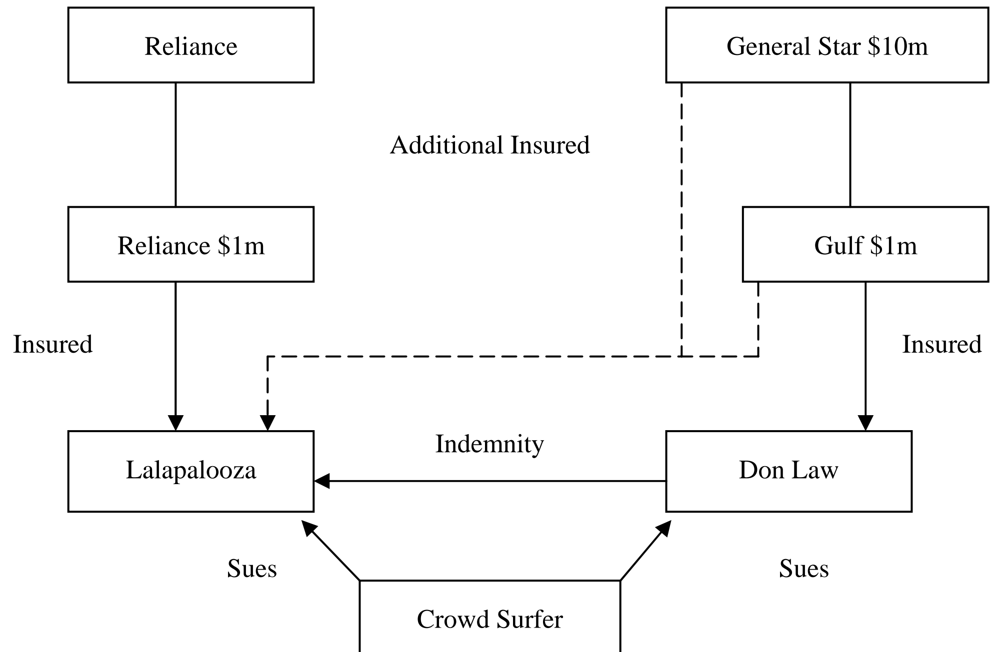
2) *How are allocation disputes complicated when an excess carrier gets involved?*

It is unlikely that the allocation questions discussed here will turn on whether the opposing insurers style themselves as "primary" or "excess" carriers.

Nonetheless, the only significant case to go against the majority trend is *Reliance National Indem. Co. v. General Star Indem. Co.*, 72 Cal. App. 4th 1063, 85 Cal. Rptr. 2d 627 (1999), which involved a dispute between a "primary" carrier and an "excess" carrier, and relied heavily on that distinction.

In *Reliance,* the artists behind the Lalapalooza music festival ("Lalapalooza") agreed with Don Law Company, Inc., to sponsor a concert in Providence, Rhode Island. In the agreement, Don Law agreed to indemnify Lalapalooza for any losses arising from the engagement (that did not arise from active negligence of Lalapalooza), and also to obtain insurance on which Lalapalooza was an additional insured. In satisfaction of the contract, Don Law had obtained a $1 million primary policy through Gulf Insurance, and a $10 million excess policy through General Star, and made Lalapalooza an additional insured on both. Lalapalooza also had its own insurance, a $1 million primary policy and an excess policy from Reliance National Indemnity Company. The General Star policy contained an "excess" type of "other insurance" clause, which purported to make it excess to Lalapalooza's Reliance policies.

During the concert, a member of the audience was injured while crowd surfing; he sued Lalapalooza and Don Law. The relationships among the parties looked like this:



The plaintiff settled for $2.1 million. Of this amount, Reliance and Gulf both contributed $1 million from their primary policies. General Star and Reliance (now as an excess insurer) split the remaining amount. Reliance then sued General Star to recover the $1 million it had paid towards the settlement at the primary level, on the theory that the indemnification agreement made General Star responsible for that amount.

The court distinguished *Reliance* from a previous California case holding that an indemnity agreement controlled the allocation between two primary insurers, *Rossmoor Sanitation, Inc. v. Pylon, Inc.*, 532 P.2d 97 (Cal. 1975), and affirmed summary judgment in front of General Star. Whether an insurer is entitled to subrogation against an indemnitor of its policyholder, the court said, depends on the "respective equities of the parties." *Reliance National Indem. Co.*, 72 Cal. App. 4th at 1081 (quotations omitted).

The court found that the equities in *Reliance* favored General Star because it was an excess carrier, while Reliance was a primary. The court apparently felt that, despite the indemnity agreement, it would be unfair to require an excess carrier to pay before a primary. *Id.* at 1083 ("If we were to accept the arguments of

Reliance, the basic rules constructing primary and excess policies would be altered."). In support of this conclusion, the court noted that primary carriers charge higher premiums and therefore have a greater expectation that they will be called upon to satisfy a judgment. *Id.*

The value of *Reliance* is dubious. One of the leading cases on the issue, *Wal-Mart Stores, Inc. v. RLI Ins. Co.*, 292 F.3d 583, 590 (8th Cir. 2002), takes issue with *Reliance*'s reasoning, and explains that focusing on the "primary" v. "excess" characterization puts the cart before the horse:

> Whether the parties are termed "primary" or "excess" depends on who is required to pay first, and that is the question presented here. The answer to this question, however, depends on the indemnity agreement because of its effect on the obligations of the parties. In this situation, RLI [insurer to the indemnitor] cannot avoid liability for the settlement by pointing to language in its policy calling itself "excess." RLI is "excess" to National Union [insurer to the indemnitee] only if we determine that National Union is liable first, and, as explained above, we do not do so because we believe the indemnity agreement controls.

Wal-Mart makes a persuasive case that the result in *Reliance* is best understood as a result of the fact that in that case, the General Star excess policy contained specific language stating that the policy would not be "subject to the terms, conditions, and limitations of . . . indemnity." *Id.* at 592.

3) *Arguing against consideration of an indemnity agreement in an allocation dispute.*

As noted above, courts have been careful to avoid stating that an indemnity agreement will *always* control the allocation among insurance companies. *See, e.g., Wal-Mart Stores, Inc.*, 292 F.3d at 592 ("an indemnity agreement *may* govern the allocation of liability") (emphasis added). Instead, courts will examine the "particular facts of the case, such as the intentions and relationships of the parties," to determine the applicability of an indemnity agreement. *Id.* at 589.

Thus, the door is open for arguments that a particular indemnity agreement should not apply to a dispute between insurers. The facts that will weigh most heavily include the following:

- The relationship between the insurance policy and the indemnity agreement: Various opinions suggest that there must be a "close factual relationship between the indemnity obligation and the insurance contracts" in order for the indemnity obligation to be taken into account. *See Wal-Mart Stores, Inc.*, 292 F.3d at 590. Thus, for instance, if the contract with the indemnification agreement also requires the indemnitor to purchase insurance, the likelihood of the entire loss being shifted to the indemnitor's insurance company is greater than it would otherwise be. *See id.* Conversely, if the indemnification agreement is silent on the insurance question, the indemnitor's insurance company has an argument to restrict the allocation question to policy interpretation.

- The terms of the insurance policy(ies) at issue: The *Reliance* case, in which the indemnitor's excess insurance policy specifically stated that it would not be subject to an indemnification agreement, provides an example of a policy wording that prevents application of the majority approach.

- The conditions precedent the indemnification obligation: If the indemnification clause requires certain facts to exist before it becomes effective (*e.g.,* that the indemnitee was not actively negligent) and those facts have not been proven in a suit among insurance companies or in an underlying action, a strong argument can be made for disregarding the indemnification agreement.

- Whether the indemnitee is an additional insured on the indemnitor's policy: If the indemnitee has been made an additional insured on the indemnitor's policy pursuant to the same business relationship that gave rise to the indemnification agreement, that will strengthen the policy's relationship to the indemnification agreement and, per the above, make the indemnity obligation more likely to be taken into account. Perhaps even more significantly, it may trigger the application of the anti-subrogation rule, under which policyholders "may not be made liable to their insurers for covered losses." *See id.* at 593. If the indemnitor's insurer takes the position that losses should be shared with its own additional

insured's insurer, the anti-subrogation rule may defeat its argument. *See id.*

- Application of the anti-subrogation rule: Note, however, that by the same reasoning, if the *indemnitor* is an additional insured on the *indemnitee's* policy, the anti-subrogation rule should prevent consideration of the indemnity agreement. *See Aviles v. Burgos*, 783 F.2d 270 (1st Cir. 1986).

Other facts will have less importance in the calculus; they include:

- Whether or not the policyholders are parties to the legal dispute among the insurance companies: Although the *Reliance* court noted the fact that the policyholders were not parties in holding that the indemnity agreement did not control in that case, [cite], the weight of authority strongly suggests that a policyholder (*i.e.,* a party to the indemnity agreement) need not be a party to a lawsuit over the allocation question in order for the indemnity agreement to be given effect, *see, e.g., Wal-Mart Stores, Inc.*, 292 F.3d at 589.

Practical: 1) *Policyholder's perspective:*

- Just let the insurers fight over this? Most often, the allocation question arises in disputes between insurers. While resolution of the question may have impacts for the policyholder—*i.e.,* on deductibles or retro premiums on the implicated policies—they often will not be as heavily invested as the insurers.
- Uncovered indemnity obligations: If a policyholder has agreed to indemnify another party, however, and its own insurance policy does not cover contractual liabilities, the policyholder may find itself exposed for the entire loss.
- Defense costs: Depending on the wording of the relevant policies and indemnity obligation, a policyholder may have a strong interest in resolving any allocation dispute among insurers early, so that its insurance does not incur legal costs that will erode its policy limits even if the question is resolved in favor of its insurer. [RACHEL – REWORD THIS??]

2) *Insurer's perspective:*

- <u>Know your policyholder's indemnification rights and obligations:</u> As shown above, the likelihood of indemnity rights affecting allocation make it wise for an insurer to inquire about its insured's indemnification agreements.
- <u>Know what other insurance is available to your policyholders, as additional insureds or otherwise:</u> Courts are more likely to accept a insurer's arguments regarding both contribution and subrogation if the insurer had knowledge of other available insurance, and designed its relationship with its policyholder accordingly.
- <u>Be aware of the trend in the cases</u>: Know going in that, in all likelihood, absent significant factual circumstances suggesting otherwise, indemnity agreements are going to control allocation questions.
- <u>To avoid indemnity agreements affecting allocation, draft policies appropriately:</u> A policy that specifically states that it will not be affected by the policyholder's indemnity obligations will mitigate against that result.

Relevant Authorities: *St. Paul Fire & Marine Ins. Co. v. American Int'l Specialty Lines Ins. Co.,* 365 F.3d 263 (4th Cir. 2004) (holding that indemnification provisions in a contract between the owner and operator of a Virginia resort controlled the insurers' liability for payment of settlement for food poisoning case brought against the owner and operator)

Hartford Cas. Co. v. Mt. Hawley Ins. Co., 20 Cal. Rptr. 3d 128 (App. 2004) (rejecting sub-contractor's insurers attempt to collect half of settlement from prime contractor's insurer, pursuant to terms of insurance contract requiring proration in case of "other insurance," because such an allocation between the insurers would negate the bargained-for indemnity agreement between the subcontractor and the prime contractor)

American Indem. Lloyd's v. Travelers Prop. & Cas. Ins. Co., 335 F.3d 429 (5th Cir. 2003) (see above)

Wal-Mart Stores, Inc. v. RLI Ins. Co., 292 F.3d 583 (8th Cir. 2002). (see above)

Continental Cas. Co. v. Auto-Owners Ins. Co., 283 F.3d 941 (8th Cir. 2000) (holding, in dispute among multiple insurers, that indemnity agreement controlled the allocation of laibility among insurers for settlement arising from accident on railroad salvage project)

Reliance National Indem. Co. v. General Star Indem. Co., 72 Cal. App. 4th 1063, 85 Cal. Rptr. 2d 627 (1999) (see above)

Chubb Ins. Co. v. Mid-Continent Cas. Co., 982 F. Supp. 435 (S.D. Miss. 1997) (see above)

J. Walters Constr. Co. Inc. v. Gilman Paper Co., 620 So. 2d 219 (Fla. App. 1993) ("to apply the 'other insurance' provision to reduce [the indemnitor's insurer's liability] would serve to abrogate the indemnity agreement")

Aviles v. Burgos, 783 F.2d 270 (1st Cir. 1986) (see above)

Rossmoor Sanitation, Inc. v. Pylon, Inc., 532 P.2d 97 (Cal. 1975) (see above)

Lee R. Russ & Thomas F. Segalla, 15 Couch on Insurance § 219:1 (3d ed. 1999)

Randall L. Smith and Fred A. Simpson, "Excess Other *Insurance* Clauses and Contractual Indemnity Agreements Shifting an Entire Loss to a Particular Insurer, 30 T. Marshall L. Rev. 215, 220 (2004)

C. What is an "insured contract"?

Background: Contractors and other service providers frequently agree to indemnify their contracting partners against liability arising out of their activities. The ability of these contractors to receive liability insurance for the amounts they have agreed to indemnify often will depend on whether they have an "insured contract" with their business partners.

Many CGL policies contain an exclusion, known as the "contractual liability" exclusion, for "for liability an insured incurs as a result of contractually agreeing to be responsible for another's actions." Philip L. Bruner and Patrick J. O'Connor, 4 Bruner & O'Connor on Construction Law § 11:53 (2005). At least in the construction industry, however, "much of the brunt of this exclusion is blunted by an exception for 'insured contracts' where one in the normal course of one's commercial activity assumes the tort liability of another arising out [of] bodily injury or liability to a third person or organization." *Id.*

Similarly, many policies contain an "insured contract" exception to the "employer's liability" exclusion.

A typical CGL contract defines "contractual liability" as:

- "'Bodily injury' or 'property damage' for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement."

A typical "insured contract" exception states that the exclusion does not apply to liability for damages:

- That part of any other contract or agreement pertaining to [the policyholder's] business . . . 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 liability that would be imposed by law in the absence of any contract or agreement.

In Depth: 1) *Genesis of "insured contract" exclusion*

Many of legal disputes between employees and their employers are covered by workers compensation statutes and regulations. One question that workers compensation laws have left somewhat

unsettled is the liability of an employer to a third party sued by an injured employee—specifically, the employer's tort liability to that third party. All state laws agree, however, that a third party may sue the employer on a *contractual indemnity* theory for liability arising from the employee.

Thus, in accordance with this legal framework, insurers created the "insured contract" exception to the "employers liability" exclusion—provide coverage for such contractual indemnity claims. For similar reasons, CGL policies contain the "insured contract" exception to the "contractual liability" exclusion.

2) *When does the "contractual liability" exclusion apply?*

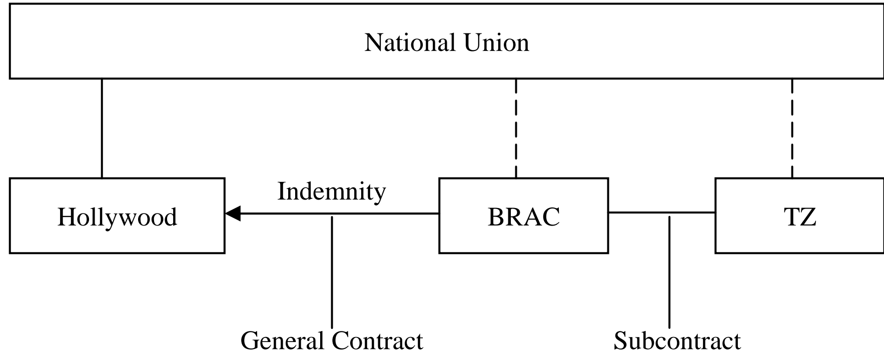
The question of whether a contract is "insured" does not arise unless a policy's "contractual liability" exclusion comes into effect. It is important to keep in mind, therefore, the limited scope of that exclusion.

As noted, the exclusion covers contractually assumed liability. The exclusion has been held to apply to "a specific assumption by the insured of liability that solely results from the negligence or contractual breach of a third party." *Broadmoor Anderson v. National Union Fire Ins. Co. of Louisiana,* 912 So. 2d 400, 407 (La. App. 2005). This does not mean, however, that whenever an indemnitee's performance leads to liability, the exclusion applies.

In *Broadmoor Anderson,* a general contractor (BRAC) agreed Hollywood Casino Shreveport to construct a hotel and casino on the Shreveport riverfront. In connection with the project, Hollywood obtained a CGL policy, which included as additional insureds all contractors and tiers of subcontractors.

One of BRAC's subcontractors, Tiede-Zoeller Inc., installed shower pans that proved to be defective. In BRAC's contract with Hollywood, BRAC had agreed to be "responsible to the owner [Hollywood] for all acts and omissions of . . . Subcontractor [T-Z] . . . ."

The relationship among the parties looked like this:



BRAC incurred costs associated with the repair of the showers, and sought coverage from National Union.

National Union denied coverage on the ground that BRAC was seeking to recover the liabilty it had assumed from T-Z. The court disagreed, explaining as follows:

> [T]he question becomes whether the failure of performance regarding the show pan installations represents BRAC's failed oblgiation owned directly to Hollywood or T-Z's failed obligation to Hollywood for which BRAC provided T-Z indemnification. Clearly, in BRAC's general construction contract with Hollywood, BRAC first obligated itself directly for the entire project including the construction of the showers. Whether the work would be perfomed through BRAC's seaparte contracts with its employees/agents or its subcontractors, BRAC was oblgiated directly to Hollywood which had no contractual privity with those employees/agents or subcontractors. Thus, the failure of performance regaring the shower installations represents BRAC's failed performance under its contract with Hollywood. This does not comport with the concept of indemnification, which is the focus of [the contractual liability exclusion]. The liability did not arise by a contract or otherwise, directly and solely between T-Z and Hollywood, with a separate agreement by BRAC for indemnification to T-Z. Accordingly, [the contractual liability] exclusion (b) . . . is inapplicable.

Broadmoor Anderson, 912 So. 2d at 407.

3) *Can agreements with indemnity clauses that violate anti-indemnity statutes qualify as "insured contracts"?*

In *Certain London Market Ins. Companies v. Pennsylvania Nat. Mut. Cas. Ins. Co.,* 106 Fed. Appx. 884 (5th Cir. 2004), the Fifth Circuit held that a contract in violation of Mississippi's anti-indemnity law would not fit the "insured contract" exception.

4) *What happens if the indemnity agreement is implied by law or industry practice, not written into the contract?*

The available authority suggests that such contracts will not qualify for the "insured contract" exception:

- In *Garnet Contruction Co., Inc. v. Acadia Ins. Co.,* 61 Mass. App. 705, 814 N.E. 2d (2004), an indemnity obligation implied by industry practice did not meet the requirements of an "insured contract."
- In *Union Ins. Co. v. Hottenstein,* 83 P.3d 1196 (Colo. Ct. App. 2003), a construction contract with an implied workmanlike warranty did not qualify as an "insured contract").
- In *New York State Ins. Fund v. Merchants Ins. Co. of New Hampshire, Inc.*, 773 N.Y.S.2d 431 (App. Div. 2004), the court found that the "insured contract" exception to the employee exclusion would not apply in the absence of a written contract.

Relevant Authorities: *Garnet Contruction Co., Inc. v. Acadia Ins. Co.,* 61 Mass. App. 705, 814 N.E. 2d (2004)

Broadmoor Anderson v. National Union Fire Ins. Co. of Louisiana, 912 So. 2d 400, 407 (La. App. 2005)

Certain London Market Ins. Companies v. Pennsylvania Nat. Mut. Cas. Ins. Co., 106 Fed. Appx. 884 (5th Cir. 2004)

New York State Ins. Fund v. Merchants Ins. Co. of New Hampshire, Inc., 773 N.Y.S.2d 431 (App. Div. 2004)

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Philip L. Bruner and Partick J. O'Connor, 4 Bruner & O'Connor on Construction Law § 11:53 (2005)