ADDITIONAL INSUREDS COVERAGE AND LEGISLATIVE CHANGES ON THE HORIZON

TAKING ISO'S 07 04 ADDITIONAL INSURED REVISIONS A STEP FURTHER

Summary: The Insurance Services Office (ISO) has published revised additional insured endorsements for the purpose of negating coverage for an additional insured for its sole negligence. Now, some states are following up on this effort with legislation. This article notes and analyzes the attempts by some states to restrict coverage for additional insureds under general liability policies. The article is written by Mr. Randy J. Maniloff.

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Topics covered:

The Additional Insured Debate: Extent of Coverage

Additional insured claims are like fingerprints—no two are identical. At least it seems that way when you consider the variation in facts, contractual provisions creating the additional insured obligations, and language of the coverage grants. But despite their unique qualities, many additional insured claims still manage to have one thing in common: the additional insured frequently secures broader coverage than was intended by the insurer.

In a typical claim scenario, without regard for potential additional insured rights, coverage is afforded if a loss satisfies the policy's insuring agreement and conditions and does not come within the terms of an exclusion. Additional insured claims demand all that, as well as, in most cases, the putative additional insured must also establish that its claim satisfies a certain causation requirement between the named insured's actions and the additional insured's liability. Some courts' interpretations of this causation element have left insurers shaking their heads in disbelief over the circumstances in which they have been obligated to provide coverage to additional insureds. See *Ohio Casualty Insurance Co. v. PetsMart, Inc.,* 2003 U.S. Dist. LEXIS 22782 (N.D. Ill.) (Based on the court's interpretation of the causation element in a vendor's endorsement—"bodily injury" arising out of "your products"—PetsMart, a retailer of a cat scratching pole, was entitled to coverage as an additional insured under the manufacturer's policy, for a claim for bodily injury caused when one of the poles fell from a store shelf.)

Last year, in an effort to stem the tide of unintended additional insured coverage, Insurance Services Office introduced changes to its various additional insured endorsements (effective July 2004 and containing a 07 04 form number suffix). At the heart of these changes was the preclusion of coverage for an additional insured's sole negligence—something that many courts around the country, based on the language of certain previous ISO endorsements, have not hesitated to provide. ISO set out to eliminate coverage for an additional insured's sole neg-

ligence by amending its endorsements to specify that coverage is only available for their vicarious or contributory negligence. (Incidentally, for an in-depth discussion of ISO's 07 04 amendments to its additional insured endorsements, see "Additional Insured Endorsements: ISO's Revisions", Casualty & Surety, Public Liability section; M.23 pages.)

Despite ISO's clearly expressed intention to limit the extent of coverage available for an additional insured, its amendments are not designed to preclude coverage for an additional insured's own negligence; unless it rises to the level of *sole* negligence.

Now comes word that several state legislatures are considering limiting coverage for additional insureds even further than accomplished by ISO's recent amendments. Putting aside various nuances in legislative provisions, bills have recently been introduced in Arizona (SB 1323), California (AB 573), Colorado (SB 05-142), Illinois (HB 0704) and Texas (SB No. 445) that would preclude an insurer from providing defense and indemnity to an additional insured for its own negligence, even when the additional insured is not solely negligent. In addition, bills have recently been introduced in Kentucky (05 RS HB 449/GA), Indiana (House Bill 1035), and Hawaii (SB 1853) that would introduce or expand the scope of anti-indemnity statutes, but which either expressly exclude their applicability to insurance or are silent on the issue.

As an example, consider Illinois HB 0704, introduced in the 94th General Assembly on February 1, 2005, which provides as follows (the proposed amendment to 740 ILCS 35/1 is indicated by the underlined text):

> Sec. 1. With respect to contracts or agreements, either public or private, for the construction, alteration, repair or maintenance of a building, structure, highway bridge, viaducts or other work dealing with construction, or for any moving, demolition or excavation connected therewith, every covenant, promise or agreement to indemnify or hold harmless another person from that person's own negligence and <u>any covenant, promise, or agreement to procure an insurance policy to indemnify or hold harmless another person from that person's own negligence</u> is void as against public policy and wholly unenforceable.

(Note that on March 10, 2005, as this article was in the final stages of preparation for publication, Judiciary I, Civil Law Committee of the Illinois House amended HB 0704 by deleting the proposed amendment and re-referred the bill to the Rules Committee. Given the fluid nature of the legislative process, it is suggested that the status of this bill should be monitored by those with an interest in the outcome.)

Another example of proposed legislation that would preclude an insurer from providing defense and indemnity to an additional insured for its own negligence is Arizona SB 1323, introduced on January 27, 2005. This legislation, for purposes of coverage for an additional insured (but not a named insured), would amend §32-1159 of the Arizona Revised Statutes as follows (note that the italicized text is to be deleted and the capitalized text is to be added):

> A. A covenant, clause, or understanding in, collateral to or affecting a construction contract or architect-engineer professional service contract that purports to INSURE, TO indemnify, to hold harmless or to defend the promisee from or against liability for loss or damage resulting from the *sole* negligence of the promisee or the promisee's agents, employees or *indemnitee* INDEMNITEES is against the public policy of this state and is void.

A succinct explanation of the rationale for this proposed legislation comes from American Subcontractors Association, Inc. (ASA), which, according to its website, is a membership trade association of 5,500 subcontractors, specialty trade contractors and suppliers in the construction industry. The following is from an ASA news release from January 2005.

> Most states have so-called "anti-indemnity statutes" that regulate the use of hold harmless terms by general contractors in written subcontract agreements, but almost no states put similar restrictions on the use of additional insured contractual requirements. In other words, anti-indemnity statutes in most states have a loophole, permitting upper-tier contractors to use additional insured arrangements to achieve the very same ends that are forbidden in use of hold harmless clauses. Courts in most states have permitted the loophole even though anti-indemnity legislation is designed to protect the public from the dangers and consequences of unsafe, or poor quality, construction. Anti-indemnity legislation such as

> Oregon's forces project leaders to use their own resources and insurance, rather than that of their subcontractors', when workers are injured, or building occupants are harmed, as a result of their own poor decision-making or poor oversight.

ASA has much to gain from the passage of Illinois HB 0704, and other similar legislation, as its members are the ones frequently obligated to procure additional insured coverage for the benefit of sometimes negligent general contractors. Subcontractors no doubt view it as unfair that their policies' experience is negatively affected by the actions of negligent parties, whose own policies may sit on the sidelines, unimpaired, when the time comes to compensate an insured party.

According to ASA, the issue goes beyond mere unfairness: it is one of avoiding a moral hazard, the chance that the existence of insurance will increase the likelihood of the insured event; this is from a brief—*Amicus Curiae* American Subcontractors Association at 12, *Walsh Construction Company v. Mutual of Enumclaw,* 338 Ore. 1 (2005), quoting *Hall v. Life Insurance Company of North America,* 317 F.3d 773, 775 (7th Cir. 2003). ASA goes on to argue the following: "In the ordinary insurance relationship, the insured is also deterred from engaging in risky activity by the notion that an accident or occurrence will result in the insurer raising its premiums"; however, "the additional insured is insulated against this prospect by the fact that it is not responsible for premium payments to the insurer and is unaffected by the raising of premiums"; *Id*. at 11, citing Mehta, "Additional Insured Status in Construction Contracts and Moral Hazard," *3 Conn. Ins. L.J.* 169, 186-187 (1996), quoted in *National Union Fire Ins. Co. v. Nationwide Ins. Co.*, 82 Cal.Rptr.2d 16, 22 (Cal. App. 4 Dist. 1999). ASA believes that if additional insureds do not have a financial motivation to exercise a high standard of care, third parties will be exposed to an increased likelihood of harm; *Id*. at 13-14, citing Mehta at 187.

Insurers also stand to benefit from anti-indemnity legislation that is expanded to include the procurement of insurance for an indemnitee's own negligence. Of course, for insurers, the benefit is more difficult to measure. After all, when an insurer is relieved of an obligation to provide coverage for an additional insured for its own negligence, the additional insured will simply seek coverage under its own policy, on which it is a named insured. Thus, unless an insurer issues policies to *only* subcontractors or general contractors, the expansion of anti-indemnity legislation to include additional insured obligations will likely be a win some/lose some situation.

The Oregon Example

While ASA notes that almost no state anti-indemnity statutes apply to additional insured obligations, an exception is Oregon, which has had such legislation since 1995. Other exceptions are Montana and New Mexico, which, since 2003, have applied their anti-indemnity statutes to additional insured requirements in construction contracts; *Id*. at 9 (see MCA §28-2-2111 and N.M Stat. Ann. §56-7-1).

Not long ago, the Supreme Court of Oregon had occasion to address, and uphold, the applicability of Oregon's anti-indemnity statute to additional insured obligations. On January 27, 2005, the Supreme Court of Oregon issued its opinion in *Walsh Construction Company v. Mutual of Enumclaw, supra*, addressing the availability of coverage for an additional insured under the following circumstances. Walsh Construction, a general contractor, entered into a subcontract with Ron Rust Drywall, Inc. to perform work on a Walsh project. Rust was obligated to name Walsh Construction as an additional insured on Rust's liability policy. Rust's policy, issued by Mutual of Enumclaw, contained a blanket additional insured endorsement that automatically afforded the coverage required.

A Rust employee was injured on the job and made a claim against Walsh. Walsh did not contend that Rust was in any way responsible for the employee's injury. Walsh tendered the claim to Enumclaw. The insurer refused it, on the basis that the additional insured provision violated ORS 30.140, which provided as follows:

> (1) Except to the extent provided under subsection (2) of this section, any provision in a construction agreement that requires a person or that person's surety or insurer to indemnify another against liability for damage arising out of death or bodily injury to persons or damage to property caused in whole or in part by the negligence of the indemnitee is void.
>
> (2) This section does not affect any provision in a construction agreement that requires a person or that person's surety or insurer to indemnify another against liability for damage arising out of death or bodily injury to persons or damage to proper-

> ty to the extent that the death or bodily injury to persons or damage to property arises out of the fault of the indemnitor, or the fault of the indemnitor's agents, representatives, or subcontractors.

Enumclaw argued that, because the additional insured provision violated the statute, Walsh was not a legally cognizable additional insured, and, therefore, not entitled to defense or indemnity. Walsh countered by arguing that its subcontract with Rust did not require either Rust or its insurer to indemnify Walsh. Instead, in Walsh's view, the subcontract required only that Rust procure insurance for Walsh's benefit. Walsh further argued that the term *indemnity* connotes unlimited liability exposure, whereas insurance limits the insurer's liability to the amount of coverage purchased. If you are not convinced by that distinction, get in line. Neither were the trial court, Court of Appeals or Oregon Supreme Court.

The Supreme Court adopted a substantial excerpt of the Court of Appeals' decision, including the following conclusion:

> "In sum, the text of ORS 30.140, and its historic evolution, strongly suggests that the statute prohibits not only direct indemnity arrangements between parties to construction agreements but also additional insurance arrangements by which one party is obligated to procure insurance for losses arising in whole or in part from the other's fault."

The Oregon Supreme Court held that the textual and contextual analysis of the statutory wording went even further than strongly suggesting its meaning, but, instead, demonstrated the legislature's intent conclusively.

Another illustration of Oregon's expanded anti-indemnity statute at work, this time in the context of an additional insured claim for construction defect, is *MW Builders, Inc. v. SAFECO Insurance Company,* 2004 U.S. Dist. LEXIS 18866. In *MW Builders*, the U.S. District Court for the District of Oregon addressed the extent of coverage for MW Builders as an additional insured under SAFECO policies issued to Portland Plastering. MW Builders subcontracted with Portland Plastering to install an exterior insulation and finishing system (EIFS) on a hotel that MW Builders was constructing. After the hotel was completed, its owner became aware of substantial water intrusion and damage to the building, caused by defects in the EIFS material.

The hotel owner filed for arbitration against MW Builders, who tendered the defense and sought indemnity from Portland Plastering and its insurer, SAFECO. SAFECO declined to defend or provide indemnity on behalf of MW Builders. MW Builders settled the claim with the hotel owner for $2,000,000 and pursued its own arbitration claim against Portland Plastering. An arbitrator determined that the fault of Portland Plastering caused 31 percent of the damage sustained by the hotel.

Relying on ORS §30.140 and the Oregon Court of Appeals' decision in *Walsh*, SAFECO argued that the agreement to procure insurance in Portland Plastering's subcontract with MW Builders, and any insurance issued pursuant to that agreement, were unenforceable. Conversely, MW Builders argued that *Walsh* was distinguishable because the subcontract did not require Portland Plastering to obtain insurance for MW Builders' own fault or negligence and because MW Builders was not seeking damages arising from its own fault or negligence. The court agreed:

> "MW Builders is not precluded, under Oregon law, from arguing that it was entitled to coverage, as an additional insured, under Portland Plastering's policy for covered damages arising from the fault or negligence of Portland Plastering. Conversely, of course, MW Builders may not recover under the SAFECO CGL policies for any damages that resulted from its own fault or negligence."

Notwithstanding the Oregon Supreme Court's decision in *Walsh* and the Oregon District Court's decision in *MW Builders*, the jury is still out on who will get the last word on Oregon's anti-indemnity statute. The 73rd Oregon Legislative Assembly has introduced Senate Bill 154, which, if enacted, would have the effect of overruling the court's decision in *Walsh*. Among other amendments related to the same purpose, the Senate Bill would add the following provision to ORS 30.140:

> (3) This section does not affect any provision in a construction agreement that requires a party to acquire insurance coverage for liability attributable to death, personal injury or property damage arising out of the construction and to name another party to the contract as an additional insured.

One thing's for certain—the beavers are busy.

The Effect of Expanded Anti-Indemnity Statutes

Given the unique features of additional insured claims, where even the slightest nuance can be outcome-determinative, and paucity of case law addressing anti-indemnity statutes that apply to additional insured obligations (none interpreting the Montana and New Mexico statutes could be located), it is difficult to predict how such statutes may affect additional insured tenders. Nonetheless, some general observations can be made.

First, additional insureds whose claims are governed by anti-indemnity statutes may be forced to turn to their own liability policies to seek coverage (subject to all terms, conditions and exclusions) for the proportionate share of a loss that is attributable to their own negligence. No longer will the additional insured's principal insurer likely be able to rely on its other insurance clause to reject any request for contribution on behalf of the additional insured. This is often-times the case now, given that, since the July 1998 version of the CGL forms, ISO's CGL forms (form CG 00 01 and form CG 00 02) contain the following provision in its other insurance clause:

> This insurance is excess over 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.

Thus, in a state that expands its anti-indemnity statute to include additional insured obligations, even a defendant that secures a complete defense as an additional insured, based on a broad duty to defend standard (assuming it was determined not to be superseded by the statute), may still be required to seek coverage from its own insurer for the share of indemnity, and reimbursement of defense costs paid by the additional insurer, that is attributable to the additional insured's own negligence. As an example, California's proposed legislation (AB 573) includes the following addition to Section 2782(b) of the Civil Code: "An indemnitee who has been afforded a defense by an indemnitor shall reimburse that indemnitor a percentage of costs and fees actually incurred by the indemnitor in that defense, equal to that indemnitee's percentage of comparative negligence or comparative willful misconduct."

Expanded anti-indemnity statutes will also likely create some challenging issues if an additional insured secures a defense, but there are allegations that it was partially negligent, and, hence, not entitled to indemnity for its own negligence. This is likely to raise some complex questions between the additional insured, the insurer providing the defense, and the additional insured's principal insurer over who controls the defense.

What's more, while it's easy for legislation to talk about parties' shares of negligence, most cases seeking damages for bodily injury and property damage are settled without the benefit of a finding of fact on this issue. Neat and tidy cases like *MW Builders*, which had an arbitrator determine that one party caused 31 percent of the damage at issue, are the exception and not the rule. If an insurer is now prohibited from providing coverage to an additional insured for its own negligence, it is likely to make it more difficult to settle cases, since an agreement among the defendants concerning relative shares of fault will be required.

Another impact of the legislation is likely to be choice of law disputes. Given the significant difference in the amount of coverage that would be available to an additional insured, depending upon whether its claim is governed by an anti-indemnity statute, disputes over choice of law seem inevitable when there are geographic contacts that can potentially support the application of more than one state's law.

Conclusion

ISO took a big step in July 2004 when it set out to adopt a fault-based additional insured standard in an effort to negate coverage for an additional insured for its sole negligence. Several state legislatures are now considering taking fault-based additional insured coverage an even bigger step further, by eliminating defense and indemnity for an additional insured's own negligence, even if it does not rise to the level of sole negligence.