The Hold Harmless Agreement and the CGL

Since most insurance agents are not attorneys, dealing with the contractual liability exposure and coverage is a bewildering and intimidating prospect. To make matters worse, ISO keeps rewording the coverage forms in ways that the average insurance agent finds arcane and mystifying. This article is an attempt to demystify this subject to some degree and hopefully to enhance understanding of this subject and the effect of recent endorsements on the CGL.

General Liability 101 instructs us that contractual liability is provided under the CGL by way of exceptions to an exclusion. The following is an analysis of the construction of this exclusion.

> **2. Exclusions**
> This insurance does not apply to:
> **b. Contractual Liability**
> "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.

So far, we have an absolute exclusion for damages for “bodily injury” and/or “property damage” which the insured becomes responsible to pay, not because of any wrongful act of the insured, but because the insured has assumed responsibility to pay in a contract or agreement.

Under what circumstances would an insured agree or contract to be responsible to pay for the legal obligations for “bodily injury” and/or “property damage” of someone else? Today there are very few business contracts that do not have some type of risk transference mechanism. Construction contracts, sales contracts and leases of premises have provisions that transfer the responsibility for legal exposures from the indemnitee to the indemnitor. The indemnitor is the party who agrees to accept the responsibility to pay and the indemnitee is the party who is relieved of the responsibility to pay. For example, in a construction contract the builder is the indemnitor and the property owner is the indemnitee. The indemnitor agrees that if the indemnitee is sued or is found to be legally responsible for damages to a third party the indemnitor will defend the suit and assume the responsibility to pay the damages.

One of the key questions in hold harmless agreements is who committed the wrongful act for which the indemnitor is being held responsible? Was it an act solely committed by the indemnitee, was it an act for which the indemnitee and the indemnitor are jointly responsible or was it an act of the indemnitor for which the indemnitee is considered vicariously responsible? These are important questions and represent the general categories into which hold harmless agreement are grouped. An agreement in which the indemnitor agrees to be responsible for the sole acts of the indemnitee (which are

sometimes called exculpatory agreements) can be limited by statute or considered unenforceable as a public policy matter. Often contracts are written to transfer responsibility for the sole acts of the indemnitee but then include a caveat such as “to the extent permissible by law”. However, as a practical matter, once the indemnitor has assumed the responsibility for the sole acts of the indemnitee, the burden is on the indemnitor to test the enforceability of the agreement.

Since contractual transfer agreements are a common business practice, how do we get coverage for these agreements? The CGL follows the absolute exclusion for Contractual Liability with two exceptions.

> This exclusion does not apply to liability for damages:
> **(1)** That the insured would have in the absence of the contract or agreement; or

This first exception to the Contractual Liability exclusions refers to liability for damages that would have accrued to the insured in the absence of the contracts. In other words, if the insured would have been legally responsible for the damage because it resulted from his own wrongful acts, such wrongful acts, otherwise covered by the CGL, would continue to be covered despite any applicable contract or agreement. If the damages are the insured’s fault and not excluded by other provisions of the CGL, then the insured is covered and any agreement to be responsible for the same damages is not relevant to coverage.

> This exclusion does not apply to liability for damages:
> **(2)** 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. Solely for the purposes of liability assumed in an "insured contract", reasonable attorney 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"; and
>
> **(b)** Such attorney fees and litigation expenses are for defense of that party against a civil or alternative dispute resolution proceeding in which damages to which this insurance applies are alleged.

This second exception to the Contractual Liability exclusion is a little more complicated and involves a definition of terms. This second exception provides coverage if the contract or agreement through which the insured has assumed the legal responsibility of the indemnitee meets the definition of an “insured contract”. The term “insured contract” is a modification of the pre-simplified term “incidental contract”. The “incidental contract” referred to five categories of contract for which coverage was included in the basic GL form. The acronym L-E-A-S-E has often been used as a memory device for these five categories.

L – Lease of premises
E – Easement or license agreements
A – Agreements required by municipalities (except for work performed)
S – Sidetrack agreement with a railroad
E – Elevator maintenance agreement

When the CGL was "simplified" in the late 1980's, ISO incorporated much of the wording of the Broad Form Contractual Liability endorsement into the new CGL. This enhancement added one additional type of contract to the definition of an "insured contract".

> **f.** 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.

This characteristic of the "insured contract" broadens coverage to include the assumption of the "tort" liability of another pertaining to the business of the insured to pay for "bodily injury" and "property damage". Notice that the provision defines "tort liability" to be a liability imposed by law in the absence of the contract. The liability imposed by law in the absence of the contract would in most cases be negligence. Therefore paragraph f. of the definition of an "insured contract" is designed to incorporate contracts where the insured would assume the liability for the "bodily injury" and "property damage" caused by negligence of the third party indemnitee. What is the negligence of the indemnitee? Is it the sole, joint or vicarious negligence of the indemnitee? Since the form is silent, we can assume that it could be any of the three. Therefore, if the insured would contractually agree to be responsible for the sole negligence of the indemnitee, it would be an "insured contract" and, providing no other exclusions applied, it would be covered.

Contractual assumptions of sole negligence are not generally a problem in construction contracts because many states, North Carolina included, place limitations, usually called anti-indemnification statutes, on such assumptions. In these situations contractual assumptions are limited to joint or vicarious liability. Often these restrictions apply only to private, non-governmental, construction contracts. Governmental construction contracts and non-construction contracts, in such a case would have no statutory restriction. Consequently many businesses outside the construction trades can be required to make indemnification for the sole negligence of the indemnitee "to the extent allowed by law".

The insurance industry has become concerned with this issue of indemnifications for the sole negligence of indemnitees. In these situations, the indemnitor is being asked to accept responsibility for the sole torts of the indemnitee and for which the indemnitee

should have their own insurance. As a result ISO has developed several endorsements to address this matter.

The first endorsement is Contractual Liability Limitations (CG 21 39) which has been around for a number of years and basically eliminates paragraph f. from the definition of "insured contracts". This endorsement functions to return the Contractual Liability coverage to the pre-simplified days where only "incidental contracts" were covered and Broad Form Contractual had to be purchased separately or by optional endorsement.

The second endorsement, Amendment of Insured Contract Definition (CG 24 26), is newer and more troubling from the insured's standpoint. This endorsement replaces the standard policy definition for "insured contracts". In its place, the endorsement uses a modified definition of "insured contracts" which affects paragraph f. or the broad form contractual provisions. The following wording is inserted into the wording of paragraph f:

> **f.** 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, *provided the "bodily injury" or "property damage" is caused, in whole or in part, by you or by those acting on your behalf.* Tort liability means a liability that would be imposed by law in the absence of any contract or agreement. (emphasis added)

This wording would restrict coverage for contractual assumptions of liability to situations in which an insured would be solely or partially negligent. What is eliminated by this wording is assumptions of liability that result from the sole negligence of the indemnitee. Therefore coverage for Broad Form Indemnifications is eliminated. This is probably good from the insurer's perspective, but it does not stop insureds from continuing to enter into broad form indemnifications. So an insured could find himself with a indemnification that is broader than the coverage provided by his CGL. Explaining this emerging gap in coverage to an insured without a law degree may be a tall order.

ISO has also begun to work this contractual limitation into the Additional Insured endorsements. The Additional Insured – Owners, Lessees or Contractors – Scheduled Persons or Organizations (CG 20 10) is one of the most commonly used AI endorsements. The wording which describes Who Is An Insured was amended in 2004 in the following manner.

A. Section II – Who Is An Insured is amended to include as an insured the person or organization shown in the Schedule, but only with respect to liability arising out of your ongoing operations performed for that insured.	**A. Section II – Who Is An Insured** is amended to include as an additional insured the person(s) or organization(s) shown in the Schedule, *but only with respect to liability for "bodily injury", "property damage" or "personal and advertising injury" caused, in whole or in part, by:* ***1.*** *Your acts or omissions; or* ***2.*** *The acts or omissions of those acting*

	on your behalf; *in the performance of your ongoing operations for the additional insured(s) at the location(s) designated above.* (emphasis added)

Now, not only can the scope of "insured contracts" be limited by the coverage for the Additional Insured, it is restricted to only vicarious liability. By including the modifications discussed above, any liability that would arise from the sole torts of the indemnitee or additional insured would not come within the scope of coverage.

All of these endorsements can create substantial limitations on the contractual liability coverage provided by the standard CGL. It can also create situations where the coverage provided by the CGL is narrower than the indemnification agreements that the insureds are signing. This creates gaps in coverage for the insureds and potential E & O exposures for agents. Agents should be vigilant on CGL renewals and new policies to flag any of these endorsements for serious review and consultation with their insureds. Fore warned is fore armed!

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