

The Priority Condition in Zurich Form U-GL-1345-B-CW May Cause Risk Transfer Problems for Upstream Additional Insureds

Zurich American Insurance Company ("Zurich") offers a proprietary "General Liability Supplemental Coverage Endorsement," form U-GL-1345-B-CW (04/13), which is used to modify and, in some cases, enhance coverage terms reflected in current ISO commercial general liability ("CGL") forms. However, form U-GL-1345-B-CW includes one change that can significantly impair risk transfer when used by a trade subcontractor who has promised additional insured ("AI") coverage to an upstream party. The change appears in **Section T. Priority Condition** and modifies SECTION III – Limits Of Insurance of the ISO CGL by adding the following terms:

In the event a claim is made or "suit" is brought against more than one insured seeking damages because of "bodily injury" or "property damage" caused by the same "occurrence" or "personal and advertising injury" caused by the same offense, we will apply the Limits of Insurance in the following order:

- (a)** You;
- (b)** Your "executive officers", partners, directors, stockholders, members, managers (if you are a limited liability company) or "employees"; and
- (c)** Any other insured in any order that we choose.

In other words, when a claim is made under the policy, the Named Insured (identified as "You") and its officers, directors, and/or employees will receive access to the policy limits before those limits are made available to any additional insured. Further, when multiple additional insureds face a claim for the same occurrence, this provision allows Zurich to dictate which party receives coverage first and in which order the remaining additional insureds will receive policy benefits. Depending on which states' law applies, this result may conflict with the rights additional insureds would otherwise have under the law. Often, the law prohibits a carrier from prioritizing the interests of one insured over another insured.¹ Meaning, absent this Priority Condition, the named insured and each additional insured would share policy limits equally when each party faces liability for the same occurrence. Consider the following example:

¹ See e.g. *Smoral v. Hanover Ins. Co.*, 322 N.Y.S.2d 12 (1971) (applying New York law, finding that an insurance carrier cannot prefer one of its insureds over another by paying the full amount of its policy to fully protect one of its insureds, while leaving another insured completely exposed); *Shell Oil Co. v. Nat'l Union Fire Ins. Co.*, 44 Cal. App. 4th 1633 (1996) (applying California law, finding insurance carrier's disbursement of its entire policy limits to indemnify one insured did not discharge its obligation to another insured but, instead, constituted bad faith); *Lehto v. Allstate Ins. Co.*, 31 Cal. App. 4th 60, 74-75 (1994); but see *Elliott Co. v. Liberty Mut. Ins. Co.*, 434 F. Supp. 2d 483, 499 (N.D. Ohio 2006) (finding an insurer is generally permitted to settle claims in good faith on behalf of one insured, even if this results in exhaustion of the policy limits to the detriment of another insured being sued); *Millers Mut. Ins. Ass'n of Illinois v. Shell Oil Co.*, 959 S.W.2d 864, 870 (Mo. Ct. App. E.D. 1997).

AB Carpentry, a carpentry subcontractor, has promised AI coverage to its GC and to the project Owner. A claim arises when a vendor's employee is severely injured after one of AB Carpentry's ladders falls on his head while he is making a delivery to the project site. The vendor's employee files a lawsuit against the AB Carpentry, the GC, and the Owner. AB Carpentry has a \$6 million tower of insurance with Zurich form U-GL-1345-B-CW attached to the primary policy. The excess policies follow-form. The vendor's employee receives a judgment for \$18 million with 33.3% liability each to AB Carpentry, the GC, and the Owner (i.e., \$6 million each). Under the Priority Condition, AB Carpentry receives the full \$6 million from the insurance tower, leaving \$0 for the GC and/or the Owner. Now, the GC and the Owner will each need to come out of pocket, or seek coverage from their own insurance policies, to pay their respective \$6 million liability to vendor's employee. While this result is favorable to AB Carpentry, it leaves the upstream GC and Owner totally void of the coverage they expect as additional insureds. This result is especially harsh on the GC, who likely has its own duty to provide contractual indemnity and AI coverage to the Owner. Ultimately, the GC will not only have to pay out of pocket or seek coverage under its practice policies for its own \$6 million exposure, but it will need to do so for the Owner's \$6 million liability as well.

If the Priority Condition was *not* on AB Carpentry's policy, all the insureds may share in the \$6 million policy limits; meaning, AB Carpentry, the GC, and the Owner would each receive \$2 million from the Zurich insurance tower. Accordingly, the GC and Owner's out-of-pocket exposure would be reduced to \$4 million each and, if they sought recovery from their own insurance policies, they would have more limits left on those policies for unrelated claims that may arise in the future.

Now, to exemplify the Priority Condition's impact on a situation where the policy limits are not completely exhausted on the subcontractor's liability, consider the same hypothetical scenario but with the following altered facts:

Instead of filing a lawsuit against the Owner, the vendor's employee only files suit against AB Carpentry and the GC. AB Carpentry's total policy limits are now \$10 million. The vendor's employee receives a judgment for \$12 million with 50% of the liability allocated to AB Carpentry and 50% allocated to the GC (i.e., \$6 million each). Under the Priority Condition, AB Carpentry receives the first \$6 million of the policies' limits. The remaining \$4 million policy limits are then distributed to the GC. This leaves the GC with \$2 million out-of-pocket exposure, which it will likely seek coverage for under its own insurance policies. While, under this set of facts, the GC receives at least some AI coverage under AB Carpentry's policies, its coverage is still less than it would have received absent the Zurich Priority Condition. Had the Priority Condition not been on the policy, AB Carpentry and the GC would have shared the \$10 million limits equally, whereby each of them receives \$5 million in coverage. Thus, the GC would only need to come up with \$1 million dollars from its own insurance policy as opposed to \$2 million to offset the difference of its \$6 million liability. In turn, the GC has more remaining limits available on its policy to pay other pending or future claims.

The Zurich Priority Condition is not only problematic for upstream parties. It can also create complications for the subcontractor who is under a contractual obligation to provide satisfactory CGL coverage to additional insureds. For example, a typical insurance exhibit in a construction subcontract requires the subcontractor to provide the GC and Owner with AI cov-

erage on a current version of the ISO CGL form. Further, the subcontract usually requires that such coverage be primary and non-contributory with respect to the GC and Owner's own practice policies. Zurich form U-GL-1345-B-CW modifies the standard ISO CGL² and its impact potentially undermines the application of primary and non-contributory coverage, even where the policy has been specifically endorsed with such a provision. While the purpose of the primary and non-contributory endorsement is to make the subcontractor's policy pay before the GC's and the Owner's policies are implicated, it does not change the priority of payment under the subcontractor's policy as between the subcontractor, GC, and Owner³. As a result, the policy may be completely exhausted by paying off the subcontractor's liability (as in the first Hypothetical above) before the GC and Owner even become eligible to claim coverage from it. In this case, it doesn't matter whose policy is primary as the GC is never entitled to coverage in the first instance because the policy has been totally exhausted on subcontractor's exposure. Accordingly, the subcontractor whose policy contains Zurich form U-GL-1345-B-CW may face liability for breach of contract due to its failure to procure standard ISO CGL coverage with an effective primary and non-contributory endorsement for its additional insureds.

Also, it's important to note that a policy with Zurich form U-GL-1345-B-CW would provide a defense to both the named insured (subcontractor) and the additional insureds (GC and Owner). However, the concern is that Zurich and its follow-form excess carriers can strategically use this endorsement to buy the named insured out of a high-risk case early by allocating its limits to the exclusive benefit of that subcontractor. Once the limits are exhausted, the carriers' duty to defend ceases. Meaning, the carriers would no longer have an obligation to defend the GC and Owner, who are now left with inadequate indemnity from the policy as well as the burden to continue defending themselves in the underlying action. While the subcontractor may have a contractual duty to defend and indemnify the GC and Owner beyond its promise to provide additional insured coverage, it can often be difficult to obtain such recovery from a subcontractor in cases with a financially catastrophic loss.

The nuanced implications of the Priority Condition in Zurich form U-GL-1345-B-CW reinforce the importance of thorough insurance vetting in advance of engaging subcontractors. If such a condition is identified from the outset of contracting, the upstream party is able to negotiate with the subcontractor and have the provision removed before the subcontractor begins work and a claim arises. SDV can assist with these negotiations and has had success getting form U-GL-1345-B-CW replaced with an adequate alternative, such as Zurich form UGL 1114-A CW.

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