INSURANCE JOURNAL'S
ACADEMY OF
INSURANCE

The 'Primary and Noncontributory' Tool
- or -
Why this Requirement Should Disappear

by Christopher J. Boggs

Upper tier contractors seek to avoid the financial costs that can arise out of bodily injury or property damage to a third party for which they could be held vicariously liable. And when allowed by statute, and sometimes even when not allowed, these upper tier contractors attempt to avoid the financial consequences arising out of injury or damage for which they and the lower tier contractor are jointly liable. In extreme cases upper tier contractors may even endeavor to relive themselves of financial responsibility for their sole negligence and liability.

Vicarious liability is created when one person or entity is or can be held legally liable for the results of another person's or entity's actions. Such indirect liability can arise out of a relationship (parent/child, employer/employee, etc.), position or contract. Also required is the right, ability or duty to control the actions of the directly liable party. Without the opportunity or responsibility to control another's actions, there can be no vicarious liability.

Owners and general contractors (the upper tier) hold a position with a certain amount of control over and responsibility for the actions of lower tier contractors. This control leaves them vulnerable to being held vicariously liable for the actions of these lower-level entities in addition to their liability for their own actions. Every state allows vicarious liability to be transferred back to the at-fault lower tier contractor (known as limited transfer).

Joint liability, as the name suggests, is injury or damage caused or attributable to both the upper tier and lower tier contractor. The term does not consider the "percentage" of fault assignable to both parties, only that the actions of both parties resulted in the injury or damage (remove the actions of one, and the injury or damage or the amount of injury or damage would not have occurred). Approximately 19 states allow the upper tier contractor to transfer joint negligence back to the jointly-liable lower tier contractor (known as intermediate transfer).

Sole negligence and liability exists when only the upper tier is found to be negligent and legally liable for the injury or damage. In sole negligence situations, there is no assignable negligence or legal liability to the lower tier contractor. According to the International Risk Management Institute (IRMI) only 10 states allow the contractual transfer of sole negligence from the upper tier to the lower tier (known as broad transfer). But there are strict guidelines for such transfer in these states; such transfer is not fully discretionary.

Accomplishing Financial Risk Transfer

Upper tier contractors have access to and utilize several "tools" to accomplish the financial risk transfer they so desire. Insurance professionals see these attempts and requests daily; so much so that it is likely the intricacies of each tool is not considered. The four most commonly requested financial risk transfer "tools" are:

- Contractual risk transfer (indemnity agreements);
- Additional insured status for the upper tier;
- Waiver of subrogation endorsement requests; and
- "Primary and noncontributory" requirements related to additional insured status.

The first three "tools" are reasonable; the "primary and noncontributory" requirement is not reasonable and needs to disappear from all construction contracts (and not be available as an endorsable option). Why this requirement should disappear is the purpose of this article. As each "tool" is explored, keep this thought in mind:

"Who is protected by and benefits from this 'tool?'" The answer to this question is provided following the discussion of each common "tool."

Contractual Risk Transfer

Legal liability is liability imposed by the courts through common law or by statute on any person or entity responsible for the financial injury or damage suffered by another person, group or entity. Such legal liability can arise from intentional acts, unintentional acts or by acceptance of liability via contract (for our purposes, via contractual risk transfer).

Contractual risk transfer through the use of indemnification wording (AKA "indemnity agreements") in construction contracts require the lower tier contractor to ***"indemnify and hold harmless"*** the upper tier contractor for its (the upper tier's) legal liability arising out of some action or inaction of the lower tier contractor. *Indemnify* is the contractual obligation placed on the lower tier contractor (transferee, subcontractor, obligor, etc.) to return the upper tier contractor to essentially the same financial condition that existed prior to the loss or claim; or to stand in the transferor's (upper tier's) place as the source for financing the legal liability. (A person or entity can be held "legally liable" without committing a negligent act.)

Hold harmless wording requires the lower tier to shield the upper tier contractor from the effects of the legal liability assignable to upper tier / transferor. Essentially, the lower tier stands in place of the upper tier, taking onto themselves the legal liability that would have been placed on the upper tier. But the extent to which the lower tier subcontractor can stand in place of the upper tier is a function of individual state statute. States often limit the amount of "blame" a transferor is allowed to transfer away by contract (as mentioned previously).

Contractual ***waiver of subrogation*** is the third "leg" of the contractual risk transfer stool. Construction contracts almost always require the lower tier to waive its right of recovery against the upper tier contractor. An insurance carrier's subrogation rights flow from the right of the harmed party to be made whole by the party responsible for the injury or damage. If the right of the lower tier contractor to recover from the upper tier contractor for the upper tier contractor's actions has been contractually waived, then the insurance carrier has **no** right to recover from the upper tier contractor.

Indemnification and hold harmless requirements effectively make the lower tier contractor's policy primary. The contractual waiver of subrogation wording assures that neither the lower tier contractor nor its insurance carrier will or even can ask the upper tier to pay for the results of the upper tier's own actions in cases of joint liability.

A word of caution regarding the lower tier's acceptance of contractual risk transfer: contractual risk transfer provisions in the construction contract's indemnity agreement must not be confused with the coverage provided by the insurance policy. The lower tier can contractually accept more liability than is covered by the insurance policy. Indemnity agreements in construction contracts shift the financial responsibility for legal liability to the lower tier contractor, but insurance is only a means to finance some amount and level of the risk accepted by the lower tier subcontractor in the contract. Indemnity agreements do NOT broaden the coverage provided by the lower tier's insurance policy.

Additionally, insurance protection for contractually-accepted tort is dependent on the definition of "insured contract" in the lower tier's CGL. If the "insured contract" definition has been altered by attachment of the CG 21 39 - Contractual Liability Limitation, the policy does not extend coverage to the contractually accepted liability. The lower tier can still accept the liability (remember, insurance protection has no bearing on what can be contractually accepted), there just will not be any insurance protection available to finance what the lower tier agreed to provide.

Who is protected by and benefits from the contractual risk transfer "tool?" The upper tier is protected when it transfers (and is allowed to transfer) the financial consequences for injury or damage to a lower tier.

Additional Insured Status

In addition to the contractual risk transfer provisions found in construction contracts, the lower-tier subcontractor is nearly always required to endorse the upper tier contractor onto its CGL as an "additional insured." This requirement is easily accomplished with the CG 20 10, the new CG 20 38 or even the CG 20 26 (be careful with this one).

To better understand the benefits of additional insured status for the upper tier, two broad concepts must be understood:
1) the parties of a liability loss; and
2) the list of "insureds" protected by a CGL policy.

- There are three parties to any liability loss:
  1) the insurance carrier;
  2) the insured; and
  3) the injured party.

  And a fact of general liability coverage: the insurance carrier cannot seek to recover from its insureds - doing so violates the risk-financing purpose of insurance.

- Contained within the CGL and by endorsement to the CGL there are four "levels" of "insured" status:
  1) the named insured(s) - the "You;"
  2) extended insureds (equal to the "you" and based on entity type);
  3) automatic insureds (i.e.: employees, volunteers, etc.); and
  4) additional insureds.

Because the additional insured is protected as an insured by the named insured's (lower tier contractor's) insurance coverage for any claim caused in whole or in part by the named insured, the insurance carrier cannot seek recovery from the upper tier. As an insured, the upper tier's policy will not be asked to contribute to the loss or even respond in subrogation.

Note: The current "in whole or in part" wording protects the additional insured against its vicarious liability for the actions of the named insured plus joint liability when both the named insured and additional insured are legally liable for the injury or damage. However, as was introduced last week, the 2013 version of the construction-related additional insured endorsements limits the breadth of protection extended to the additional insured to the level allowed by the subject state's anti-indemnification statutes. If the state is a "limited transfer" state, the upper tier is protected only for its vicarious liability for the actions of the lower tier. In "intermediate transfer" states, the protection extends to include both vicarious and joint liability. A "hiccup" exists when the parties are in a "broad transfer" state. Neither the current nor the revised additional insured endorsements seem to extend protection all the way to the sole negligence of the upper tier. The newly worded endorsements still includes the phrase, "...in whole or in part...." By interpretation, the lower tier named insured must be partially at fault for the protection to apply to the upper tier.

Who is protected by and benefits from the additional insured "tool?" The upper tier is protected as an insured on the lower tier's policy. There is no benefit for the lower tier named insured (some postulate that providing additional insured status may actually be detrimental to the lower tier, a different debate for a different day).

Waiver of Subrogation Endorsement

Contracts spill over into the realm of the ridiculous when contractual risk transfer provisions, contractual waiver of subrogation and the requirement to extend additional insured status to the upper tier contractor are followed by the requirement to endorse a waiver of subrogation in favor of the upper tier contractor onto the CGL policy. This is beyond a "*belt and suspenders*" approach bordering on unilateral self-preservation by the upper tier contractor.

As stated previously, subrogation rights flow from the injured party's right to recover from the at-fault party. The waiver of subrogation wording in the construction contract removed that right. Secondly, as an additional insured, the insurance carrier cannot subrogate against the upper tier anyway.

By attaching the waiver of subrogation endorsement in favor of the upper tier, the insurance carrier, for the third time, is blocked from seeking recovery from the upper tier contractor for its actions in causing injury or damage. For clarification, the endorsement is actually titled, "Waiver of Transfer of Rights of Recovery Against Others to Us" (CG 24 04).

Who is protected by and benefits from the waiver of subrogation endorsement? In practice, only the upper tier contractor named in the endorsement benefits from this tool.

The "Primary and Noncontributory" Requirement

"No one knows what 'primary and noncontributory' means, but everyone wants it."
"Primary and noncontributory" is an "inclusive" contractual requirement that can be met only if the protection extended to the upper tier contractor is provided on both a primary basis and a noncontributory basis.

Analyzed in the context of a construction contract, what is the supposed goal of the "primary and noncontributory" requirement? Upon initial review, the apparent intent of the contractual "primary and noncontributory" requirement is the protection of the upper tier contractor's financial resources from the effects of the lower tier's individual or joint negligence in causing injury or damage to a third party. But the upper tier's financial resources are amply protected by all the other "tools" previously detailed. Thus this provision is not required to accomplish this goal.

Theoretically, the "primary and noncontributory" requirement applies to only the protection extended to the upper tier as an additional insured? Some espouse and disseminate the idea that the "primary and noncontributory" requirement is intended to benefit none but the upper tier contractor's **insurance carrier**. In essence, these professionals see this contractual requirement as a prohibition against the lower tier's insurance carrier's ability to seek contribution from the upper tier's insurance carrier following a joint liability loss or claim (or even the sole negligence of the upper tier in those states where this level of transfer is allowed).

If protecting the upper tier's insurance carrier is the true purpose of the "primary and noncontributory" requirement, why should the upper tier care so much about its insurance carrier that they would place this provision in any contract? The only financial "skin" the upper tier should be concerned with is its own; and the upper tier contractor isn't going to be asked to contribute because of the other three "tools" discussed previously.

Evidently, some risk managers and attorneys think the "primary and noncontributory" provision does more than simply protect the upper tier's insurance carrier against potential contribution. If, in fact, all the requirement accomplishes is protecting the upper tier's insurance carrier against contribution, the upper tier transferor should not be using the contract to protect its insurance carrier because: 1) the insurance carrier is not a party to the contract; and 2) the carrier is not a party in the construction process (like an architect or engineer).

Should the contractual "primary and noncontributory" requirement go away? Yes, absolutely.

Likewise, should ISO and other insurance carriers endorse policies to state that coverage is provided on a "primary and noncontributory" basis? No; unless such extension is specifically limited by the endorsement's wording (i.e. payout is capped at the limit of coverage provided by the CGL or the amount specified in the construction contract, whichever is less).

Who benefits from and is protected by the "primary and noncontributory" tool? The answer depends on who you believe. If it protects none but the upper tier's insurance carrier it should go away because it is inappropriate to attempt to govern another insurance carrier via a contract between the upper tier and lower tier contractor. (Remember, insurance is nothing but a risk financing mechanism that should not be governed by outside contracts.) If this is the goal, would a waiver of subrogation endorsement in favor of the insurance carrier accomplish the same thing (well, maybe if the term "contribution" replaced "subrogation")?

If, however, the "primary and noncontributory" requirement is intended to protect the upper tier's own financial resources, the provision is absolutely unnecessary and must be removed. The upper tier has far better tools (as discussed in this article) to manage its financial risk exposure.

Conclusion

The "primary and noncontributory" requirement needs to disappear from construction contracts. But recent developments make this unlikely:

1) some insurance carriers have created proprietary endorsements extending coverage on a "primary and noncontributory" basis - just so they can be "competitive;" and

2) Insurance Services Office has created an endorsement stating that coverage is provided on a primary and noncontributory basis (see last week's article). Such reactions may create liability the industry did not intend or anticipate (no good deed goes unpunished).

Be warned, this conversation cannot end with this article. The insurance industry must work to educate all interested parties on the realities of this improper or unnecessary contractual requirement.