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Education Matters

Additional Insured endorsement and exhaustion of coverage

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This is the first article in a series of articles on additional insured endorsements. For additional articles see future issues of PIA magazine.

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In many types of businesses, it is customary for contracts to require that the upstream parties in the business relationship be made "additional insureds" under the downstream parties' policies of insurance. To help you educate your insureds on the importance of Additional Insureds endorsements, this article explores some of the hidden pitfalls posed by the specific language of the numerous versions of Additional Insured endorsements and what impact Additional Insured status has on the availability of coverage under primary, excess and other policies (the "exhaustion" of coverage issue).

We are aware of at least a dozen "standardized" Additional Insured endorsements used by insurers. Some authors have suggested that when you add in the number of nonstandard manuscript forms written by various insurers, there may be more than 300 different Additional Insured endorsement forms in use.

Typically, a liability insurance policy begins with a "grant of coverage," where the insurer agrees to pay the sums that the insured "becomes legally obligated to pay as damages because of bodily injury, [or] property damage" arising out of an "occurrence" that is covered under the policy. An occurrence simply is an accident (as opposed to an intentional act or omission).

Additionally, and equally as important, the policy states that the insurer has the duty to defend the insured against any lawsuit that seeks these damages. This duty applies even if the lawsuit is groundless, false or fraudulent. Additional Insured endorsements extend these duties under an insurance policy to any party that qualifies as an additional insured. Thus, these endorsements transfer risk from one contracting party to another by having the downstream party's insurance policy provide coverage to the upstream party as if those policies belonged to the upstream party.

Blanket or scheduled?

Additional Insured endorsements come in two general styles: "blanket" and "scheduled." As the name implies, a "blanket" endorsement provides additional insured coverage to anyone who is required to extend coverage under a written contract. A "scheduled" endorsement requires that the additional insured actually be identified by name. This can be done in the endorsement itself or in a separate schedule of additional insureds. (We will examine the specifics of these types of endorsements more fully in our subsequent articles in this series).

Exhaustion of coverage

The Additional Insured endorsement also impacts the priority of insurance coverage available to the parties and how that coverage is used up (or "exhausted").

The standard terms of insurance policies are structured using a concept of "horizontal exhaustion" when coverage is provided by multiple insurance policies. For example, although most contracts in the construction business require that primary insurance be provided to the downstream and upstream parties under the downstream party's commercial general liability policy, followed by the downstream party's excess liability policy (this is "vertical exhaustion"), these policies normally are written using the concept of "horizontal exhaustion," which is a different coverage scenario. Under the horizontal-exhaustion concept, all CGL policies that provide coverage to the upstream parties must be exhausted completely before coverage is triggered under the first excess policy.

This has been described as the "rising-bathtub" allocation method. Imagine that every CGL policy is represented by a set of blocks that lies side-by-side along the bottom of a bathtub, with the excess policies stacked on top. When the water rises in the bathtub, each of the CGL policies gets wet (or is triggered) before any of the excess policies are submerged. Thus, coverage is triggered "horizontally" across *all* of the CGL policies before any excess coverage above is triggered "vertically."

If an insured agrees to provide additional insured coverage under his or her policy to the other party and agrees that all the coverage to the additional insured's CGL policies be primary, the horizontal-exhaustion concept used in the insurance policies is not appropriate. Under the "rising-bathtub" scenario, an insured would have to have his or her CGL policy amended so the CGL policy would cover the entire floor of the bathtub. Then the insureds excess/umbrella policy would have to be the second layer to cover the entire bathtub. All other parties' CGL policies would rest in a third layer on top of the insureds excess policy. The excess policies of the other parties would rest on top of that as a fourth layer of coverage. As the tub begins to fill and the water begins to rise (i.e., claims begin to be filed), the CGL policy, and then the excess policy are *the only* policies that get wet (or are triggered). Thus, the CGL excess policies will provide "primary" coverage for all claims until the point where they are exhausted and no more coverage is available. Only then will any other available policies from the other parties be triggered.

Final thoughts

Additional Insured endorsements come in a variety of formats, each of which is designed specifically to provide a certain amount of coverage for certain activities. These endorsements are designed to transfer risk between parties. When acting in connection with a primary coverage endorsement, the Additional Insured endorsement can even impact the availability and exhaustion of other insurance coverage.