Legal Separation—The Severability Test in the CGL

June 2011

Armstrong, Inc., is a landlord that rents space to various tenants in a commercial office building it owns located on 1 Main Street. On 3 Main Street, immediately adjacent to Armstrong's building, is a small industrial building owned and occupied by Gordon Manufacturing Corporation, a manufacturer of plastic resins.

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Gordon Armstrong owns 100 percent of the shares of both Armstrong, Inc., and Gordon Manufacturing Corporation. All American Insurance Company, or AAIC, provides primary liability coverage to Armstrong and Gordon Manufacturing—AAIC has issued the latest edition of the Insurance Services Office, Inc. (ISO), commercial general liability (CGL) policy, listing both Armstrong, Inc., and Gordon Manufacturing Corporation as *named insureds* on the same policy.

The Incident

Due to a malfunction in one of the process boilers at Gordon Manufacturing's plant, an explosion occurs. Fortunately, no one is injured, as the explosion took place after working hours, but the explosion and ensuing fire damages not only Gordon's manufacturing building but also results in extensive damage to Armstrong's office building. While Armstrong, Inc., has property insurance to protect against the direct damage, Armstrong did not purchase any business income insurance. Armstrong promptly brings a claim against Gordon Manufacturing for the loss of the use of its office building.

Gordon Manufacturing had not purchased any equipment breakdown or boiler and machinery insurance. It tenders Armstrong's claim to AAIC, its CGL insurer, to pay to defend Gordon and to pay damages (if any) to Armstrong. It is quickly found that Gordon improperly maintained the boiler, and thus the explosion and resulting damage is adjudicated to be caused by the negligence of Gordon Manufacturing. Damages of $200,000 are awarded to Armstrong, Inc.

Does AAIC owe defense to Gordon Manufacturing and damages to Armstrong, Inc., from a claim made against Gordon Manufacturing by another named insured on the same CGL policy?

Common Misconceptions

There is much confusion surrounding the ability to sue yourself and cross-suits. These are explained below, along with an illustration to help clarify these issues.

Suing Yourself

The oft-repeated "you cannot sue yourself" is usually trotted out about now. But does a lawsuit by one valid, separate business entity against another valid, separate business entity amount to "suing yourself"? While there may be instances in which such a complaint would not be allowed (i.e., illusory purposes, fraud, etc.), each entity has been properly created for legitimate business purposes.

Put another way, a corporation is separate and distinct from its shareholder(s) (owner(s)). Because Gordon Armstrong happened to own all the shares of both entities does not mean he is "suing himself." The lawsuit is lawful.

Cross-Suits

What about the "cross-suits" or "insured versus insured" exclusions? There is no broad "cross-suits" or "insured versus insured" exclusion within a *standard* ISO CGL policy. While it may be common for certain insurers, particularly nonadmitted or "surplus lines" insurers, to add such exclusions by endorsement to a CGL policy, the standard ISO CGL actually contains a condition—"Separation of Insureds"—that often *allows* coverage for suits by one insured against another insured (more on separation of insureds later).

While the CGL policy does include *some* coverage restrictions for suits between insureds (for example, an employee is not covered for suits by a co-employee), there is indeed broad coverage for many "insured versus insured" claims. But why would anyone need such coverage?

An Illustration

An umbrella policy purchased by a not-for-profit entity has an endorsement that excludes any claim by "any insured against any other insured." Despite an erroneous insistence that the umbrella followed exactly the terms of the underlying CGL policy (the any insured versus any insured exclusion was *not* included within the CGL policy), the organization is potentially left without coverage in one very important area. As members of the organization are all considered insureds (via Additional Insured—Club Members endorsement CG 20 02), the organization may not have coverage for a suit brought by a member against the organization for injuries suffered while the member was engaged in one of the organization's numerous activities. There is little question that the organization would indeed be unpleasantly surprised by an umbrella claim denial when faced with a large lawsuit by an injured member.

Exclusion J

The CGL policy (exclusion j. (1)) eliminates coverage for property damage to property that "you own, rent or occupy." In this exclusion, "you" refers to any organization with the status of named insured—*either* Armstrong, Inc., or Gordon Manufacturing Corporation. Clearly, the claim by Gordon Manufacturing against Armstrong involved property that an organization with the status of named insured owned or occupied. But Gordon Manufacturing did not own or occupy the property

at 1 Main Street for which Armstrong is making a claim. Does that make a difference in coverage? Indeed, it does.

Separation of Insureds

The separation of insured condition states, in essence, that, except for the limits (the policy limits will not be increased by the number of persons insured), the CGL policy applies to each named insured as if that named insured was the *only named insured* AND that the policy applies separately to *each insured* against whom claim is made or suit is brought.

The effect is that AAIC must apply the CGL policy to Armstrong and Gordon Manufacturing as if a separate CGL policy was issued to each named insured.

Several courts have discussed the purpose and coverage implications of the separation of insureds condition at some length. Here are but two examples:

> Severability of interest provisions were adopted by the insurance industry to define the extent of coverage afforded by a *policy issued to more than one insured*. *Sacharko v. Center Equities P'ship*, 479 A.2d 1219 (Conn. App. 1984) [Emphasis added]

> Commentators indicate that severability of interest clauses were inserted in standard forms in the mid-1950s to make "it clear and certain that the named insured and the omnibus or additional insureds are to be *treated separately*, and *that the exclusions* or *other coverage tests* should apply *to the particular insureds seeking coverage*." *Davis v. National Indem. Co.*, 135 Ga. App. 793 (1975), quoting Plummer, "Automobile Policy Exclusions," 13 *Vand. L. Rev* 945, 955 (Oct. 1960) [Emphasis added]

It is important to note the reference to "coverage tests." In other words, properly applying exclusions in conjunction with the separation of insureds condition requires the insurer perform a test to give effect to the principle of severability.

> The term "the insured" as used in this policy must be examined by first applying the "severability of interests" test. "The insured" does not refer to all insureds; rather the term is used to refer to each insured as a separate and distinct individual apart from any and every other person who may be entitled to coverage thereunder. *When a claim is made against one who is an "insured" under the policy, the latter is "the insured" for the purpose of determining the [insurer's] obligations with respect to a claim*. *Commercial Standard Ins. Co. v. American Gen. Ins. Co*., 455 S.W.2d 714 (Tex. 1970) [Emphasis added]

In summary, exclusions apply only to the insured seeking coverage (but see "The Insured versus Any Insured" below). In our example, the insured seeking coverage was Gordon Manufacturing. Although one of the named insureds (Armstrong, Inc.) owned the premises that suffered the damage, in applying the "severability test" to the suit by Armstrong against Gordon Manufacturing, the question that AAIC must ask is whether Gordon Manufacturing—the entity against whom the suit has been brought—owns the property that has been damaged. As Armstrong, Inc., and *not* Gordon Manufacturing owns the 1 Main Street property for which the claim is being made, the exclusion for property damage to property owned by "you" does not eliminate coverage as the insured against whom the claim was made did not own the property.

Despite our misconceptions, the answer to the question is *yes*—AAIC must pay for the defense and damages on behalf of Gordon Manufacturing resulting from the lawsuit by Armstrong, Inc.

Expansion of Coverage

The severability test required by proper application of the separation of insureds condition is generally considered to expand coverage.

> When determining whether an exclusion should bar coverage for an additional insured, the presence of a severability of interests clause in the policy is construed to mean the policy should be read as if each insured were the only insured. Such a reading *tends to expand coverage*, which courts rationalize on the ground that the severability of interests clause is the insurer's implied recognition of a separate obligation to others.… *Truck Ins. Exch. v. BRE Props., Inc.*, 81 P.3d 929 (Wash. App. 2000), quoting Douglas R. Richmond and Darren S. Black, "Expanding Liability Coverage: Insured Contracts and Additional Insureds," 44 *Drake L. Rev*. 781, 808 (1996) [Emphasis added]

Just how far severability expands coverage is hotly debated. At the heart of the issue is how exclusions are to be applied that exclude coverage for *any insured* rather than those exclusions that exclude coverage for *the insured*.

The Insured versus Any Insured

In our example, the exclusion applied only to property owned by "you." If the exclusion was worded to apply to property owned by *any named insured*, the severability test may have yielded an entirely different result.

While there is decidedly a mix of opinions on this issue, consider the following.

> The effect of the separation of insureds clause on a particular exclusion in an insurance contract thus depends on the terms of that exclusion. If the exclusion clause uses the term "the insured," application of the separation of insureds clause requires that the term be interpreted as referring only to the insured against whom a claim is being made under the policy. If however, *the exclusion clause uses the term "any insured," then application of the separation of insureds clause has no effect on the exclusion clause; a claim made against any insured is excluded*.
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> To hold that the term "*any* insured" in an exclusion clauses means "the insured making the claim" would collapse the distinction between the terms "the insured" and "any insured" in an insurance policy exclusion clause, making the distinction meaningless.
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> Moreover, construing the term "any" the same as the word "the" in an exclusion clause when an insurance policy contains a separation of insureds or severability of interests clause *would require a tortured reading of the terms of the policy*. We should not give the terms of a contract such an expansive reading without a definite expression of the parties' intent that we do so. *Bituminous Cas. Corp. v. Maxey*, 110 S.W.3d 203 (Tex. App. 2003) [Emphasis added]

A Practical Example

What is evident is that an exclusion that excludes coverage for *any* insured may be treated differently from an exclusion that excludes coverage for *the* insured. In other words, it is important to know whether the CGL exclusion applies to "any insured" or to "the insured" in order to properly apply the exclusion in conjunction with the severability test.

Presuming for a moment that the reasoning found in the case quoted above is applied, one word can make a dramatic difference in how coverage applies. In instances where the exclusion applies to "the insured," the exclusion applies only to the insured seeking coverage; if the exclusion applies to "any insured," the exclusion applies to all insureds.

Liquor Liability

Exclusion c. in the CGL policy, the liquor liability exclusion, eliminates coverage for bodily injury or property damage for which *any insured* may be held liable for the reasons listed, including by reason of any statute, ordinance, or regulation regulating the sale, gift, distribution, or use of alcoholic beverages.[1]

Consider a landlord who rents space to a pub and obtains from the pub status as an additional insured on the pub's CGL policy. Assume a patron falls and is injured on the premises and then files a complaint against both the pub and the landlord. In the suit, the patron alleges liability against the pub based in part on the fact that the pub was operating in violation of state statute and local ordinance by serving alcohol after hours and that it served two drinks for the price of one (prohibited by state law). However, the allegations of the patron *against the landlord* are different—the patron alleges that the landlord's failure to properly maintain the exterior stairs contributed to the patron's fall.

Would the landlord have coverage as an additional insured on the CGL policy of the pub? It is clear that liability is not being imposed on the landlord due to violation of a statute, ordinance, or regulation relating to selling, serving, or furnishing alcohol. Using the severability test might allow coverage for the landlord. After all, the CGL policy is to apply "separately to each insured against whom claim is made or suit is brought." However, using the reasoning quoted in the Texas case above, the pub's CGL policy would not provide any coverage to the landlord as an additional insured.

Even using the severability test, the wording of the exclusion must be considered—the liquor exclusion eliminates all coverage if *any insured* is held liable for violation of statutes, ordinances, or regulations relating to alcohol—which is precisely the case here.

The exclusion applies to all persons who are insureds in the policy—the application of the separation of insureds clause has no effect; a claim made against any insured is excluded.

The Supreme Court of California very directly addresses this coverage issue.

> California decisions uniformly have held that, viewed in isolation, a clause excluding coverage for particular conduct by "an" or "any" insured, as opposed to "the" insured, means that such conduct by one insured will bar coverage for all other insureds under the same policy on claims arising from the same occurrence. This rule applies even when the insureds seeking coverage did not themselves participate in the act for which coverage is excluded, and even when their liability is premised on their own independent acts or omissions that would otherwise be covered. *Minkler v. Safeco Ins. Co.*, 232 P.3d 612 (Cal. 2010)

Of course, while it is possible that the outcome in our pub illustration may be in favor of coverage for the landlord in different jurisdictions, "the majority of courts have concluded that the presence of a separation of insureds provision does not serve as a basis to afford coverage to an innocent co-insured when the exclusion applies to the conduct of any insured."

> Maniloff, Randy and Jeffery Stempel. *General Liability Insurance Coverage.* New York: Oxford University Press, 2010, p. 179.

Conclusion

When more than one insured is involved in a claim, it is vital to consider the separation of insureds condition and the "severability" test to properly apply CGL policy exclusions. The implications of severability are often overlooked, misunderstood, or simply dismissed. Separation of insureds is of particular importance in situations in which the CGL policy lists multiple named insureds, such as a consolidated insurance program (owner or contractor controlled insurance program) or "wrap-up" insurance programs.

CGL exclusions must be applied only to insureds seeking coverage and not *all insureds* when coverage is eliminated for "the insured" or those with the status of "you." On the other hand, those exclusions that apply to "any insured" likely eliminate all coverage for all insureds.

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[1]The liquor exclusion " … applies only if you are in the business of … selling, serving or furnishing beverages." As the CGL on which the landlord is an additional insured is that of the pub, and the pub has the status of "you," the exclusion is triggered. That the landlord does not sell, serve, or furnish liquor is immaterial to whether this exclusion is triggered.

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