Insurance Law
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Employers Liability and Insurance Coverage in the Construction Industry

Recent decisions of the Illinois Supreme Court have addressed the availability of insurance coverage for certain contractual risk transfers, particularly, whether coverage is available for the risk transferred by general contractors to their subcontractors and the subcontractor’s insurance carriers for on-the-job injuries to the subcontractor’s employees. The most recent case, *Virginia Surety v. Northern Insurance Co.*, 224 Ill. 2d 550, 571, 866 N.E.2d 149 (2007), however, has also left an area of uncertainty that should be of particular concern to subcontractors and their employer’s liability (EL) carriers. Is the risk transferred covered by insurance? In the wake of *Virginia Surety*, insurance carriers and subcontractors alike should review the language of their policies to confirm that coverage comports with expectations.

The facts in *Virginia Surety* are typical in the construction industry. DeGraf, the subcontractor, entered into an agreement with Capital, the general contractor, that required DeGraf to “indemnify and hold harmless” Capital “to the fullest extent permitted by law” from claims for bodily injury to one of DeGraf’s employees caused “in whole or in part by its own negligence.” A DeGraf employee was injured on the job site and sued Capital. Capital filed a third party complaint for contribution against DeGraf, which DeGraf in turn tendered to Northern, its commercial general liability (CGL) carrier and to *Virginia Surety*, its employer liability (EL) carrier.

In Illinois, the type of indemnification Capital required of its subcontractor, DeGraf, is a typical risk transfer in the construction industry and is commonly referred to as a “Braye waiver of the Kotecki cap.” In *Kotecki v. Cyclops Welding*, 146 Ill. 2d 155, 585 N.E.2d 1023 (1991), the Illinois Supreme Court established that an employer’s maximum exposure in a contribution action is limited to the amount of its workers’ compensation liability (statutory indemnity and medical payments). In the wake of *Kotecki*, an employer’s liability in a contribution action was deemed to be capped at its liability under the Illinois Workers’ Compensation Act. This means that the maximum amount of contribution a general contractor could obtain from a subcontractor for suits brought against the general contractor by the subcontractor’s employee is limited to the amount of the subcontractor’s liability to its employee in workers compensation payments.

In *Braye v. Archer Daniels-Midland Company*, 175 Ill. 2d 201, 676 N.E.2d 1295 (1997), the Illinois Supreme Court, however, held that an employer could voluntarily waive its *Kotecki* cap through the execution of an agreement or contract. The effect of an employer waiving its “Kotecki cap” is that if an employee of the subcontractor sues the general contractor, then the general contractor can sue the subcontractor for non-capped contribution. Absent the subcontractor’s agreement to waive its *Kotecki* cap, the general contractor would be liable to the employee for the difference between the amount of the employer’s assessed contribution and the employer’s workers’ compensation liability payments as a joint tortfeasor. For this reason, many general contractors require subcontractors seeking to obtain work to waive their *Kotecki* cap.

Typically, the subcontractor’s EL policy provides coverage up to the subcontractor’s liability under the Workers’ Compensation Act. However, where the subcontractor has waived its *Kotecki* cap, it becomes potentially liable for damages in excess of its Workers’ Compensation liability. Consequently, as the court in *Virginia Surety* court pointed out, questions persist regarding whether the subcontractor, its EL or its CGL insurer is liable for the difference between the subcontractor’s liability under the Workers’ Compensation Act and the liability assessed against the subcontractor for contribution to the general contractor.
The issue before the court in Virginia Surety was whether DeGraf’s policy with Northern, its CGL carrier, would provide coverage to DeGraf for any liability in excess of DeGraf’s liability under the worker’s compensation incurred as a result of DeGraf’s agreement with Capital. The court did not, however, consider the coverage obligations of Virginia Surety, DeGraf’s EL Carrier.

The insurance contract between DeGraf and Northern included a standard employer’s liability exclusion. However, Northern’s policy also had an exception to that exclusion which covered bodily injury to an employee assumed under an “insured contract.” The policy defined “insured contract” as “that part of any other contract pertaining to [DeGraf’s] business under which [DeGraf] assumes the tort liability of another party to pay for ‘bodily injury’ or ‘property damage’ to a third person or organization.” The policy defined “tort liability” as “liability that would be imposed by law in the absence of any contract or agreement.”

The question before the court, therefore, was whether the agreement between DeGraf and Capital constituted a covered “insured contract.” In other words, the court had to determine whether DeGraf, by agreeing to waive its right to limit its liability to Capital to its liability under the Contribution Act and to allow Capital to seek full reimbursement in contribution, assumed the “tort liability” of Capital. In its opinion, the Virginia Surety court analyzed prior Illinois cases that interpreted similar agreements between general contractors and subcontractors and the coverage obligations of the CGL and EL carriers for such agreements.

In Christy-Foltz v. Safety Mutual Ins. Co., 309 Ill. App. 3d 686, 722 N.E.2d 1206 (4th Dist. 2000), the court considered the coverage obligations of the subcontractor’s EL policy. The court determined that in agreeing to waive its Kotecki cap, the subcontractor/employer “voluntarily assumed liability” for its pro rata share of damages in contribution in excess of its liability under the Workers’ Compensation Act. Further, the court concluded that there was no coverage under the subcontractor’s EL policy for damages incurred as a result of the subcontractor’s Kotecki waiver because any such damages would constitute a “loss” voluntarily assumed under the terms of the policy. Christy-Foltz, 309 Ill. App. 3d at 693.

The exclusionary provision in the EL policy stated, in pertinent part: “In no event shall the CORPORATION [the EL Carrier] be liable for any loss or claim expenses voluntarily assumed by the EMPLOYER under any contract or agreement, express or implied * * *.”

Section (E)(1) of the policy defined the term “loss” as follows:

“Loss” - shall mean actual payments made by the EMPLOYER to employees and their dependents in satisfaction of (a) statutory benefits, (b) settlements of suits and claims, and (c) awards and judgments.

Applying the terms of the insurance policy, the Christy-Foltz court held that a Kotecki waiver was a loss that was voluntarily assumed by the insured and was therefore excluded from coverage pursuant to the exclusionary provision in the EL policy. Id.

Thereafter, the Illinois Appellate Court Second District, in Michael Nicholas vs. Royal Insurance, 321 Ill. App. 3d 909, 748 N.E.2d 786 (2nd Dist. 2001), and West Bend Mutual Insurance Company v. Mulligan Masonry, 337 Ill. App. 3d 698, 786 N.E.2d 1078 (2nd Dist. 2003) considered the coverage obligations under a CGL policy for a Kotecki waiver. The language contained in the CGL policies at issue in Michael Nicholas and West Bend was identical to the CGL policy under review in Virginia Surety.

In both Michael Nicholas and West Bend, the subcontractors argued that their agreement to waive their Kotecki cap constituted an “insured contract” within the meaning of the CGL policy. The CGL carriers argued that pursuant to Hankins vs. Pekin Insurance Co. 305 Ill. App. 3d 1088, 713 N.E.2d 1244 (5th Dist. 1999), the term “tort liability” in the policy’s definition of “insured contract” meant “negligence liability.” In Hankins, the court construed the coverage obligations of the CGL for an indemnity provision in the non-construction setting. In that case, a cartage operator (Hankins) entered into an agreement with a motor freight carrier (Rudolf) which stipulated that Hankins would indemnify the carrier for all claims caused by Hankins’ own acts or omissions. Hankins, 305 Ill. App. 3d at 1089. The Hankins court held that an “insured contract” is one in which one of the contracting parties agrees to assume someone else’s tort liability, that is, someone else’s liability for their own negligence. Id. at 1093. Relying on Hankins, the CGL carriers in West Bend and Michael Nicholas argued that because DeGraf, in waiving its Kotecki cap, was only agreeing to be held liable for
unlimited contribution and was not accepting the “tort liability of another party,” the policy’s definition of insured contract was not met.

In Michael Nicholas, however, the court determined that the language in the exception was ambiguous because nothing in the policy definition stated that “tort liability” must be equated with “negligence liability.” Michael Nicholas, 321 Ill. App. 3d at 914. Both the Michael Nicholas and West Bend courts acknowledged that the subcontractor was not indemnifying the general contractor for the general’s own negligence. Id.; West Bend, 337 Ill. App. 3d at 706. The West Bend court explained, however, that as a joint tortfeasor, the general contractor could be held jointly and severally liable for all of the employee’s damages. Such joint and several liability was the general contractor’s joint tort liability even though a portion could have been attributable to the subcontractor’s own negligence. West Bend, 337 Ill. App. 3d at 698.

Both Michael Nicholas and West Bend determined that by agreeing to waive its Kotecki protection, the subcontractor agreed to assume the “tort liability” that would otherwise potentially be imposed on the general contractor by law as a joint tortfeasor. Id.; Michael Nicholas, 321 Ill. App. 3d at 914. The West Bend court stated, “[i]ndemnification clauses like the ones at issue [in the construction industry] are intended to shift the tort liability that would otherwise be imposed on [the general contractor].” West Bend, 337 Ill. App. 3d at 706. Accordingly, both courts in Michael Nicholas and West Bend concluded that a Kotecki waiver constituted an “insured contract” under the terms of the CGL policy and, therefore, held that the CGL carrier was liable to its insured for damages resulting from a Kotecki waiver.

The West Bend court also examined the EL policy and determined that the EL policy excluded “liability assumed under a contract.” Id. at 707. Citing Christy-Foltz, the court determined that the exclusion in the EL policy was triggered when the insured waived its Kotecki cap. Id. The language of the EL policy was not cited in the court’s opinion.

In Virginia Surety, however, the court rejected the analysis in West Bend and Michael Nicholas and determined that there was no coverage under the terms of the CGL policy for a Kotecki waiver. The court determined that a Kotecki waiver was not an “assumption of liability.” Virginia Surety, 224 Ill. 2d at 550. In the court’s view, “the waiver of the Kotecki cap does not shift liability.” Id. at 568. The Virginia Surety court agreed with the court in Hankins finding that the “tort liability” must mean “negligence liability.” Id. at 565. The court determined that DeGraf’s agreement with Capital only obligated DeGraf to indemnify Capital for DeGraf’s own negligence. Id. Therefore, the court held that the “insured contract” provision in the CGL policy that required DeGraf “to assume tort liability of another party” was not triggered, and the CGL was not obligated to defend or indemnify its insured. Id.

Virginia Surety stands for the proposition that CGL carriers with policy language similar to the language in that case are not liable to their insured for any damages incurred as a result of a Kotecki waiver. However, while the court did not construe the coverage obligations of the EL for a Kotecki waiver, the court’s interpretation of a nature of a Kotecki waiver could put insureds and EL carriers at risk.

The Virginia Surety court held “to the extent that Michael Nicholas, West Bend, and Christy-Foltz would hold otherwise, they are overruled.” Id. at 570. Since Michael Nicholas and West Bend reached the exact opposite conclusion of the court in Virginia Surety, the impact of Virginia Surety on those cases is clear. But the impact on the Christy-Foltz decision – and on insurers – requires more careful analysis to determine the extent to which Christy-Foltz is contrary to Virginia Surety, as well as the extent to which it is still good law.

In reaching its decision, the court stated, “[f]urther, we reject the Virginia Surety’s, as well as the Christy-Foltz, Michael Nicholas, and West Bend courts’ assertion that the employer somehow assumes the joint and several liability of the third party non-employer.” Id. at 569. Put simply, the Virginia Surety court disagreed with the assertion in those cases that a Kotecki waiver is an assumption of liability.

Accepting that Virginia Surety is contrary to Christy-Foltz to the extent that Christy-Foltz determined that a Kotecki waiver was an assumption of liability, the result in Christy-Foltz is still the same: there is no coverage under the EL policy to its insured for damages incurred as a result of its insured’s Kotecki waiver because any such damages would constitute a “loss” under the terms of the exclusionary provision in the policy. Christy-Foltz, Inc. v. Safety Mut. Cas. Corp., 309 Ill. App. 3d 686, 693 (Ill. App. Ct. 2000). As previously noted, the EL policy at issue excluded any “loss” voluntarily assumed by the employer.
Applying the terms of the insurance policy, the Christy-Foltz court held that a Kotecki waiver was a loss that was voluntarily assumed by the insured and was therefore excluded from coverage pursuant to the exclusionary provision in the EL policy. This is different than the language in the CGL policies construed in West Bend and Michael Nicholas, which considered whether the insured had assumed a “liability.” The court’s determination that there was no coverage under the EL policy for a Kotecki waiver was dictated by the language in the exclusionary provision of the EL policy irrespective of the court’s interpretation of the nature of a Kotecki waiver. Therefore, post Virginia Surety it appears that Christy-Foltz is still good law.

Since Christy-Foltz was decided in 2000, many have interpreted it to mean that there is no coverage under the EL policy for damages incurred by the insured as a result of a Kotecki waiver. Neither Virginia Surety nor subsequent case law has addressed the impact of its decision on the coverage obligations of the EL carrier. It appears, however, that post Virginia Surety, EL carriers may become liable to their insureds as a result of a Kotecki waiver depending on the language used in the exclusionary provision of the EL policy.

It is important to note that the exclusionary provision contained in the EL policy under review in Christy-Foltz was not a standard ISO policy. Further, in Christy-Foltz, the insured argued “that the nature of the liability imposed remains contributory in nature, rather than contractual * * * as such, coverage for all contribution liability is provided under the policy at issue, notwithstanding its agreement to waive the protections of the Compensation Act (Ill. Rev. Stat. 1991, ch. 48, pars. 138.1 to 138.30 (now 820 ILCS 305/1 et seq. (West 1998)) as dictated in Kotecki.” Id. The EL carrier argued, however, that that the language of the insurance policy, rather than the nature of the potential liability, dictates the scope of coverage. The court agreed.

The court concluded that the “clear and commonsense meaning” of the exclusionary provision in the EL policy intended to exclude from coverage any loss “voluntarily assumed” by the insured. The policy definition of “loss” specifically encompassed the kind of payments the insured would have made as a result of a Kotecki waiver. The policy does not make any reference to a Kotecki waiver as an assumption of liability.

Many of the Standard ISO Employer Liability Policies May Expose the EL Carrier to Liability for an Insured’s Kotecki Waiver

In contrast, the exclusionary provision contained in many of the standard ISO EL policies excludes coverage to an insured for the assumption of a “liability assumed under a contract.”

As explained above, Virginia Surety specifically held that a Kotecki waiver is not an assumption of a liability. Accordingly, in the wake of Virginia Surety, EL carriers which use the standard ISO policy language are likely at a substantial risk of exposure for any damages incurred by its insured as a result of a Kotecki waiver because a Kotecki waiver does not constitute an assumption of liability pursuant to the terms of the EL policy.

The significance of the court’s decision in Virginia Surety is twofold. First, the CGL policy the court construed was a standard ISO CGL policy. Therefore, under Illinois law, the CGL insurer will generally not be liable to its insured for any damages in excess of the insured’s workers’ compensation liability. The decision stands for the premise that the CGL insurers (for the most part) are not obligated to defend and indemnify an insured. Second, while the court did not expressly construe the coverage obligations of the EL under the terms of the policy for a Kotecki waiver, the court’s decision could place some EL carriers at risk to exposure for damages in excess of its insured’s Kotecki cap.

In the aftermath of Virginia Surety, EL carriers should recognize their potential exposure and should review and revise their policies if and as appropriate to unambiguously exclude coverage beyond the benefits provided for under Illinois workers’ compensation law, notwithstanding the existence of a Kotecki waiver between their insured and a general contractor.
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