HORIZONTAL OR VERTICAL EXHAUSTION AT THE EXCESS LEVEL

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April 2020

When there is a continuous trigger occurrence over several years, must an insured exhaust all insurance policies horizontally before it can move to the excess carriers above. For primary carriers, California case law, at this time, requires the insured to exhaust all primary policies before moving up to the excess carriers at the next level. *Community Redev. Agcy. v. Aetna Cas.,* 50 C.A. 4th 329 (1996). But when an insured exhausts all primary carriers, can they move to one or more of the triggered time frames and require all excess carriers in the tower of coverage pay on the claim as each lower policy exhausts until the claim is satisfied (vertical exhaustion). Or, must the insured move horizontally along with the next layer of excess carriers, over the triggered time frame and exhaust all excess policies horizontally over the entire time frame before moving up to the next layer (horizontal exhaustion)?

In a more simplified form, regarding the exhaustion of excess policies, should vertical exhaustion be allowed? Should the Community Redevelopment rule concerning primary exhaustion continue to exist?

Montrose Chem. Corp. v. Superior Court (S244737) is pending before the California Supreme Court. It should resolve the horizontal versus vertical exhaustion debate for excess carriers in a continuous trigger situation. The case may address the Community Redevelopment Agency rule requiring horizontal exhaustion at the primary level.

Factual History

Montrose Chemical Corporation manufactured and distributed DDT between 1947 and 1982 in Torrence, California. Ultimately, they were sued for causing continuous environmental damages in the Port of Los Angeles over a substantial period between the early '60s and middle '80s. Montrose purchased over 115 Excess CGL Policies covering that time. Some policies Montrose purchased were issued before the inclusion of the pollution exclusion. Others were issued after the inclusion of the pollution exclusion became common. Montrose claimed it had exhausted its primary coverage over all relevant periods. There is some dispute as to whether Montrose exhausted all primary carriers according to Defendant Travelers Insurance. They point out that Montrose only contends "its exposure exceeds the Primary coverage." Montrose had multiple layers of excess coverage above each primary policy that was in effect during each triggered year. Montrose made a valiant effort to short circuit this massive coverage litigation involving years of excess coverage and asserted that they could make an elective stacking of policies and vertically exhaust the excess policies in a single year (or selected years). Not surprisingly, the excess carriers disputed the Montrose position and asserted that horizontal exhaustion of excess carriers across all triggered years was required before excess carriers above were obligated to pay.

The Court of Appeal initially rejected Montrose's appeal from the trial court's ruling that horizontal exhaustion was required. The California Supreme Court ordered the court of appeal to rehear the case. On rehearing, the court of appeal again rejected the Montrose argument for elective stacking and vertical exhaustion based on the specific language of the excess insurance policies involved. In effect, the court of appeal ruled that the trial court, in this case, (and other cases like it), must make a detailed comparative analysis of the various coverage provisions contained in each policy. The appellate court felt it was necessary to determine the relative positions of each carrier, that is, determine whether the "other insurance" clauses effect when a policy is triggered. If so, determine which carriers are primary and which are excess to each other, even if they are on the same level. Coverage counsel and insurance experts will love this case. It is the full employment act of 2017.

Travelers also argued that the matter is premature because Montrose has not demonstrated that it has exhausted its underlying primary policies. It only "contends" that the liability in the case exceeds the policy limits of the primary policies it has elected to exhaust. (The appellate court never reached this issue, but the Reply Brief raises it; no questions were asked relative to the issue at oral argument).

The appellate court held that Montrose was not entitled to the relief it sought as a matter of law (selective vertical exhaustion), but also held that the trial court's decision was not one it could adopt either.

The trial court required that all horizontal excess policies on the same level be exhausted before the excess policies above were implicated. The appellate court refused to adopt a single exhaustion scheme that applies to Montrose's entire coverage portfolio, **instead they directed each policy be interpreted according to its terms**.

The appellate court discussed the definition of Primary and Excess insurance and pointed out that Excess Insurance: "(1) can be written as excess to specifically identified coverage or coverage provided by a particular insurer; (2) or, it can be written as coverage in excess of an identified primary policy; or (3) as coverage in excess of an identified primary policy **and the "applicable limits of any other underlying insurance providing coverage to the insured**, **or similar phrasing**.'"

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Published by IRMI:
International Risk Management Institute, Inc.
Jack P. Gibson, Publisher
Bonnie Rogers, IRMI Editor
12222 Merit Drive, Suite 1600
Dallas, TX 75251 • (972) 960–7693
www.IRMI.com

In *State of Calif. v. Continental Ins. Co.,* the policies involved promised to "pay on behalf of the insured ALL SUMS which the insured shall become obligated to pay by reason of liability imposed by law … for damages …." 55 Cal. 4th 186 (2012). The Supreme Court held the "all sums" language permitted (absent anti-stacking language provisions, statutory prohibitions, or judicial intervention) the horizontal stacking of coverage. The appellate court noted that in this Montrose case, many of the excess policies do not include the "all sums" language; thus, the Continental case language is of limited use. The appellate court said the issue was not whether an insured could access policies written for different policy years, but the order or sequence in which it may or must do so.

The appellate court discussed the definition of Primary and Excess insurance, and pointed out that excess insurance "may be written as excess of (1) a particular policy or policies… (2) coverage provided by a particular insurer…, or (3) excess of an identified policy and the applicable limits of any other underlying insurance providing coverage to the insured." *Montrose, v. Superior Ct,* 14 CA 5th 1306 at 1320.

The court focused on the "other insurance" clauses. It looked to the specific lan-

guage of each policy to determine whether elective vertical exhaustion could occur or whether horizontal exhaustion was required. After making that analysis and reviewing the policies, the court noted several provisions in the excess policies that required them to reject the Montrose argument that the excess policies attach upon the exhaustion of lower layer policies within the same policy period. For example:

1. **The insuring agreements** in some policies had language that provided the excess policies were not triggered until exhaustion "**of all available insurance**."

2. **The Retained Limit Clause** may have language stating the companies liability is limited to an ultimate net loss above the insured's retained limit, which is defined as the greater of the total of the applicable limits of the underlying policies listed in the declarations, **and any other underlying insurance collectible by the insured**.

3. **The** "**other insurance clause**" **may**, **in effect**, provide that the policy at issue is above both scheduled and unscheduled policies using language such as: "if other collectible insurance is available to the insured covering a loss also covered hereunder, this policy shall be in excess of and not contributory with such other insurance."

4. **The definition of** "**loss**" **in terms of other insurance;** the policy may use the following language: "the sums paid as damages in settlement of a claim or in satisfaction of a judgment … after making deductions for all recoveries, salvages and other insurance (whether recoverable or not) other than the underlying insurance and excess insurance explicitly purchased to be in excess of this policies.

5. "**Other Insurance clauses which negate coverage;**" Some policies have language in the Other Insurance clauses that say there is no coverage if the insured has other insurance.

The court specifically stated that each policy had different language and that each policy had to be analyzed separately.

It also faced the argument that the "other insurance clauses" were only relevant and only applied to the rights and duties between insurers, not the insurer's obligations to the policyholder or the policyholder's right to recovery under the policy. The court discussed *Dart Indus. v. Commercial Union Ins. Co.* and distinguished it on the grounds that Dart involved primary carriers, not excess carriers. (2002) 28 Cal. 4th 1059. Thus, the duty to defend and indemnify were triggered at different times. Stating that Dart's statement that apportionment among insurers has no bearing on the insurers' obligations

to the policyholder does not apply in the present context (involving excess carriers).

As it relates to obligations between carriers, the court of appeal noted that 'Other insurance Clauses" may be relevant to determine whether two policies provide the same level of coverage, and thus, the order in which excess policies attach. Even if the "other insurance" clause is the same in each policy, an examination of other provisions in the policy may cause one policy to be excess to the other. *See Carmel Dev. Co. v. RLI Ins Co.,* 126 Cal App 4th 503 (2005).

The Insurance Backdrop Relevant to the Issues

In 1995, the California Supreme Court ruled that: "an insurer on the risk when continuous or progressively deteriorating damage or injury first manifests itself remains obligated to indemnify the insured for the entirety of the ensuing damage or injury." *Montrose v. Admiral,* 10 Cal. 4th 645, at 686-87.

In *Aerojet-Gen. Corp v. Transport Indem.,* the court reaffirmed that in continuous loss cases, successive insurers on the risk are separately and independently obligated to indemnify the insured. 17 Cal. 4th 38 at57, fn 10 (1997).

State of Calif. v. Continental Ins. Co., 55 Cal. 4th 186 at 200-201 (2012), rejected "pro-rata" exhaustion of excess policies and ruled that insured's with continuous damage may obtain coverage from any triggered policy under an "all sums with stacking interpretation".

The Court of Appeal case of *Community Redev. Agcy. v. Aetna Cas. & Surety Co.* ("CRA"), held that all primary policies on the risk with a duty to defend had to be exhausted before any excess policies could be triggered. 50 C.A.4th 329 (1996). In effect, CRA required horizontal exhaustion with respect to primary policies.

In *Dart Indus., Inc. v. Commercial Union Ins. Co.,* held that the "other insurance" clauses in the involved primary policies are not relevant to insurer disputes with policyholders, but only to actions between insurers for contribution. 28 Cal. 4th 1059 (2002) (Reaffirmed by 4th District Court of Appeal in *State of Calif. v. Continental Ins. Co.,* 15 C.A.5th 1017 (2017)).

Important Language in the Excess Policies

The Attachment Language: Each excess policy, according to Montrose, provided that the coverage attaches in excess of a predetermined amount of underlying insurance, usually described in a (1) Schedule listing the policies; or (2). reference to a specific dollar amount and a schedule of underlying insurance on file with the insurer; or (3) reference to specific dollar

amount in same policy period and identification of one or more underlying insurers; or (4) reference to a specific dollar amount of underlying insurance that corresponds with the combined limits of the underlying policies in that period. Montrose Opening Brief, pgs. 17, 18.

Other Insurance Language: Each of the policies at issue, in this case, contains an "other insurance clause." The standard language reads as follows, with some variations:

> If other valid and collectible insurance with any other insurer is available to the Insured covering a loss also covered by this policy, other than insurance that is in excess of the insurance afforded by this policy, the insurance afforded by this policy shall be in excess of and shall not contribute with such insurance.

Also, see the court of appeal description (above) of how "other insurance" clauses appear in different parts of the excess policies, indicating that they may alter priority and status of the carrier's position, vis-à-vis other carriers.

Although not discussed, one should consider the possible effect or impact of "non-cumulation" and "prior insurance" clauses mentioned in *In re Viking Pump,* 27 N.Y. 3d 244 (2016), and *Olin Corp v. One Beacon Am., Inc.,* 864 F. 3d 130 (2017), which recently dealt with the vertical/horizontal exhaustion issue in New York.

The Briefs before the California Supreme Court

Appellant's (Montrose) Opening Brief before the Supreme Court raises three main points of error concerning the underlying Court of Appeal decision.

1. **First**, **Montrose asserts California law permits insureds to obtain coverage from any triggered policy** (**vertical exhaustion**). **The court of appeal decision**, **which requires horizontal exhaustion**, **is inconsistent with existing law**.

   Montrose argues that the insured has an immediate right to indemnification. *Aerojet,* 17 Cal 4th 38 at 57, fn10. That in a continuous trigger type case, each policy can be called upon to pay up to its limits and, once the policy limits of a given insurer are exhausted, the insured is entitled to seek indemnification from any of the remaining insurers on the risk. *State of Calif. v. Continental Ins. Co.,* 55 Cal. 4th 186 at 200, 201. Montrose asserts the "other insurance" clauses have no bearing on the matter because they only apply to inter-insurer allocations after the insured is fully indemnified. Montrose Opening Brief, pg. 25; *See State of Calif. v. Continental Ins. Co.,* 15 C.A. 5th, 1017 at 1032, 1034 (2012); *Armstrong World Indus., Inc. v. Aetna*

Cas. and Surety Co., 45 C.A. 4th 1 (1996); as well as the *Dart Indus., Inc. v. Commerial Union,* 28 Cal. 4th 1059 (2002) (which Montrose says establishes that "other insurance" clauses do not affect an insured's right to recovery under triggered excess policies and the horizontal exhaustion principle discussed in CRA applies only to primary insurance).

2. **The requirement of horizontal exhaustion at the excess level is inconsistent with the specific triggering language of Excess policies, which trigger the exhaustion of the policy(ies) below within a particular time frame. "Other insurance" clauses do not apply.**

Montrose argues that the language of the excess policies provides that they are triggered upon exhaustion of specified policies identified as lower-tier excess or primary policies in specified amounts purchased in a specific underlying period. What the insured did not agree to was that it could not make claims on that excess policy until all other excess policies at that level in other periods had exhausted. The insurers are, in essence, trying to effectuate a pro-rata allocation under the guise of horizontal exhaustion rules. Montrose argues that the case law requires the insurers to seek contribution, not burden the insured with litigating the relative rights of the excess insurance carriers before it is fully indemnified.

Montrose asserts that "prior to the holding by the Court of Appeal in this case, no California case had ruled that a policy holder must exhaust its excess **indemnity** coverage horizontally across multiple separate policies and years as a prerequisite to vertically accessing other, independently triggered excess policies". Montrose Brief, pg, 26, 27.

3. **Third, there are public policy issues that indicate horizontal exhaustion, in effect, rewrites the policy to place unfair and improper burdens on the insured.**

Montrose points out that mandatory horizontal exhaustion (1) forces policyholders to litigate against more restrictive policies in every triggered period instead of permitting the insured to select towers of policies that do not have restrictions in coverage; (2) policyholders would, in effect, be punished for purchasing additional coverage in other policy years; (3) the insurance carriers, who agreed to be triggered after a certain amount of underlying coverage (e.g., $1M) would have the benefit, at the insured's ex-

pense, of getting an additional underlying coverage buffer of all excess insurance purchased before and after the policy year at the underlying level (perhaps $40M) and (5) the horizontal exhaustion rule unfairly delays indemnity by compelling the policyholder to litigate the inter-insurer contribution claims while sorting out the "other insured" clauses and relationships (in effect determining the pro-rata shares of each policy).

The Answer Brief written by 18 insurance companies led by Continental Casualty Company counters with four main points, which they believe supports their position that the law requires horizontal exhaustion.

1. **First**, **the carriers believe the plain language of the policies and the "other insurance" clauses dictate the application of the Horizontal Exhaustion rule**. The carriers assert the normal rules of construction apply for insurance policies using provisions in their ordinary and popular sense and construing it in the context of the instrument as a whole. They cite the policy language specifically referring to liability not attaching until "after deductions for all other insurances" and similar language. (See the types of clauses referenced in the Court of Appeal decision described above). Their point is that the Excess policies do not cover any loss incurred by the insured until the insured exhausts both (1) any vertically underlying policies and (2) any other underlying insurance. (Carrier's reply brief, pg. 29). The carriers very strongly assert that all of the "other insurance" clauses, wherever they appear in the policy, cannot simply be written out of the coverage language. The insurers distinguish the *Dart v. Commercial Union,* calling attention to the fact that it involved three primary carriers, two of which had other insurance clauses and one of which had a missing policy. 28 Cal. 4th1059. The issue was whether the insurer with the missing policy had a duty to defend. The court held the missing "other insurance" clause was not relevant. It did not hold that "other insurance" clauses are only applicable in coverage battles between the carriers in contribution contests. In this case (Montrose), the "other insurance clauses" appear in excess policies at different levels and cannot possibly conflict in a way that would leave the insured without coverage. *See Carmel Dev. Co. v. RLI Ins. Co.,* 126 C.A. 4th 502, 516 (2005); *See also Olympic Ins. Co. v. Employers Surplus Lines Ins. Co.,* 128 C.A. 3d 563 (1981) (involving a dispute between two primary carriers and one excess carrier with "other insurance" clauses). The court ignored

the clauses on the primary level as mutually repugnant but gave effect to the clause at the excess level. "Other insurance" clauses appear in insurance policy contracts entered into between carriers and the insured. They are not contracts entered into between the carriers. Contribution rights between carriers arise out of equitable considerations, not a contract. Reply Brief, pgs. 37-39.

2. **Second**, **they assert horizontal exhaustion is the logical result of the court's prior rulings concerning Horizontal stacking and one giant Uber-policy language**. The California Supreme Court allowed in continuous loss matters the "all-sums-with-stacking" rule which stacks policies horizontally across time frames rather than artificially breaking the loss into distinct periods, which in effect forms one giant "uber-policy." The insurers argue that the court's language in *State of Calif. v. Continental,* stating that the insured would have immediate access to the insurance it purchased did not reject Horizontal exhaustion. 55 Cal 4th at 201. That was not at issue in the Continental case. They argue that each layer of excess coverage across the time frames of the continuous event becomes an "uber-policy." The insurers rebut Montrose's position that Horizontal exhaustion results in an "allocation scheme." Instead, they point out that "pro-rata" versus "all sums" controls how much a policy pays; exhaustion controls when a policy pays. Reply Brief, pg. 49, fn. 9.

3. **Third**, **they assert Horizontal exhaustion is the fairer approach and is more closely akin to the reasonable expectations of the parties concerning which party would pay first**. The insurance carriers argue that Excess carriers charge less premium than the carriers to which they are excess because their risk is less. Montrose claims it is unfair to let the excess carriers benefit from the additional lower level of insurance that becomes a buffer to the excess carrier's liability when horizontal stacking is allowed. The carriers point out that the insured benefits from the horizontal stacking in terms of increased coverage under the fiction of a continuous trigger. The carriers point out that Montrose has not explained why Horizontal exhaustion, as required at the primary level, is not a good rule for the excess level. Reply Brief pg 52.

4. **Fourth**, **and finally**, **they assert that Montrose's assertion that horizontal exhaustion will cause massive problems for insureds in trying to settle long term tail**

> **type cases is not supported by reality**. The carriers assert there is no evidence that the Horizontal Exhaustion rule will spur extensive and exhaustive litigation needlessly involving the insured in years of disputes. Montrose responded at oral argument that it had made demands on its excess insurers, which resulted in denials of coverage (no exhaustion yet) bringing us here before the Supreme Court. Reply Brief, pg. 57.

The Answer Brief by Travelers Casualty and Amicus Briefs by United Policy Holders and Santa Fe Braun, Inc., did not add anything substantive to the argument. Except, Travelers asserted that Montrose did not exhaust the primary policies. Montrose only contended it had incurred "liabilities sufficient to exhaust." While this argument appeared in the Insurer's Brief, it was not discussed at oral argument.

Questions by the Judges at Oral Argument

The parties argued this case before the California Supreme Court on January 7, 2020. As one might expect, counsel for both parties was experienced, prepared, and extremely articulate. Rather than summarize their argument, which followed their briefs. It may be more instructive to try and summarize as accurately as possible the questions the justices asked, which gives a little insight into their concerns. Below is a synthesis of questions heard, not exact quotes:

1. Is it possible to draft a policy that provides specifically for horizontal exhaustion?

2. Policies in the charts in briefs appear different from policies before the court. Does the court have all the necessary policies before it?

3. Does "other insurance" have different meanings in different contexts in the policies? Seems unusual.

4. If the court rules in favor of horizontal exhaustion, does that eliminate the mutual repugnancy issue with respect to the other insurance clauses at excess level?

5. Do the excess policies follow form; does that cause a problem or solve it?

6. Should contract interpretation allow carriers to, in effect, modify the terms of its policy by importing additional coverage to buffer its trigger point?

7. Is this a sequencing issue? Where do the equities lie? What about the modification of the attachment point by adding additional years of underlying coverage before a trigger is activated?

8. How can you price insurance fairly and accurately if excess carriers are allowed to require exhaustion all across the board?

9. Do underwriters take into account other insurance?

10. Going forward, what should our reading of the law be when terms are ambiguous as to whether vertical or horizontal exhaustion is permitted

11. Does the term "other insurance" mean something different in a primary policy as opposed to an excess policy?

12. If an excess policy defines when it is to be triggered, such as listing specific policies, shouldn't it be more specific in listing policies for prior periods?

13. Can you have excess policies that do not follow form?

14. How do you respond to Montrose's argument that earlier carriers with no pollution exclusion get to import additional coverage buffers and modify their trigger point by adopting the horizontal exhaustion rule?

15. This is not a simple problem. What if the underlying policy does not pay because it claims an exclusion applies. Can you go to the upper-level excess?

16. Horizontal exhaustion is not consistent with the trigger point language in the excess policies except for the "other insurance" clauses. What does "other insurance" clause mean

17. Why is this a problem that arises with excess carriers; is it a problem with the primary carriers?

18. How do you see the case of *Community Redev. Agcy. v. Aetna Cas. & Surety Co.,* 50 C.A. 4th 329 (1996)? Is it still viable?

Other Cases in Other States

The insurers also briefed cases in other jurisdictions. Key cases in other states include: *Olin Corp. v. OneBeacon Am. Ins. Co.,* 864 F. 3d 130 (2d Cir. 2017); *In re Viking Pump, Inc.,* 27 NY. 3d 244 (2016); *Trammel Crow Residential Co. v. St. Paul Fire & Marine Ins. Co,* 2014 WI. 12577393, at p.2 (N.D. Tex. Jan 21, 2014) (unpublished opinion).

In *Viking Pump,* New York adopted the vertical exhaustion rule. *Olin Corp.* followed *Viking Pump.* The "non-cumulation" and "prior-insurance" clauses were significant issues, which seem to be somewhat similar to the "other insurance" clauses raised in Montrose. From an equity standpoint, *Hoerner v. ANCO Insulations, Inc,* (La. Ct. App. 2002) ruled:

"horizontal exhaustion applied where the supreme court had previously adopted the all-sums-with-stacking rule. The insurers argue that "if the insureds have the benefit of having access to "all sums" stacked into an "uber-policy", they should also have an obligation to exhaust the full policy limits of the "uber-policy" before moving up to the next layer. Insured's reply brief pg. 50.

Final Comments

The California Supreme Court has heretofore structured rules that favor the insured in terms of maximizing its access to insurance policies and coverage. It seems to recognize that the insurance carriers can draft around whatever rule they adopt by way of standard language or endorsement. Still, until that happens, they need to resolve the stacking and exhaustion issue in a way that allows the insured and the victims of long term injury to efficiently move forward and put an end to the litigation while protecting the carrier's rights and interests. Look for a resolution that encourages quick access to necessary coverage, minimizes coverage disputes, and pushes the complex priority disputes off to carrier contribution litigation.

However, carriers, brokers, and insureds need to heed the reasonable probability that in the future, policies and endorsements will be written to try and adopt a stacking or exhaustion method that is perceived to be more economically advantageous to one party or the other. This is a discussion and a negotiation that will extend over multiple coverage years and put a premium on the advice of knowledgeable professionals to attempt to maintain a consistent and cohesive coverage plan for the insured.