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Managing Multiple Coverage Claims — Part II

Law360, New York (February 06, 2009) -- Last week, we introduced a scenario in which your client calls you to say he has a coverage issue for you to solve. Someone has made a claim against him and he wants to know how to coordinate his insurance policies to cover the matter.

A couple days later, he walks into your office, throws a stack of policies on your desk, wheels around and leaves without saying a word. The question of how to go about determining the priority of coverage can be answered by that Rubik's Cube sitting on your bookshelf: you just have to line up your colored sides properly.

Part one of last week's article discussed "other insurance" provisions, the orange squares on your Rubik's Cube; and the nature and level of coverage, the purple squares. Part two of this article looks at the final two pieces of the multiple-policies puzzle: horizontal versus vertical exhaustion and choice of law.

Blue Squares: Horizontal Versus vs. Exhaustion

You're not sure yet, but you believe the matter you are analyzing may involve a claim of injury that takes place over the course of several years. Your stack includes several primary and excess liability policies that span a number of years during which the claimed injuries may have occurred.

The next issue to line up, therefore, is whether all primary insurance must be exhausted over the course of the years of exposure before an excess policy can be triggered, a concept known as horizontal exhaustion.

The companion question is whether an excess policy can be triggered if the primary policy immediately beneath it has been exhausted — even if other primary insurance exists, a concept known as vertical exhaustion.

Horizonal Exaustion

You recall previously reading cases from Illinois and California that dealt with these issues, and pull them from your research file. These two jurisdictions follow the horizontal exhaustion rule.

In Kajima Construction Services Inc. v. St. Paul Fire & Marine Ins. Co., 227 Ill.2d 102 (2007), Illinois strongly adopted horizontal exhaustion and asserted its dominance over possible conflicts such as the targeted tender rule, under which an insured can designate one primary insurance policy to defend a suit out of a number of applicable primary insurance policies.

In Kajima, the insured, a general contractor, had two primary insurance policies: its own policy with Tokio Ins. Co. and a different policy with St. Paul through its subcontractor.

After an employee was injured, the insured made a "target tender" to St. Paul; however, when St. Paul failed to accept the targeted tender, the insured turned to Tokio to handle the claim.

The Kajima court addressed the tension between the horizontal exhaustion rule and the targeted tender rule, especially in a situation that does not have a continuous tort.

If an insured decides to make a targeted tender to one insurance company, does that company's primary and excess policies both need to be exhausted before the insured can turn to another primary insurer?

In discussing the horizontal exhaustion rule, the Kajima court looked to United States Gypsum Co. v. Admiral Insurance Co., 268 Ill.App.3d 598 (1994), the first case in Illinois to address vertical and horizontal exhaustion.

In rejecting vertical exhaustion, the Gypsum court stated, "This would permit Gypsum to pursue coverage from certain excess insurers at the exclusion of others.

Such a practice would blur the distinction between primary and excess insurance, and would allow certain primary insurers to escape unscathed when they would otherwise bear the initial burden of providing indemnification." Kajima at 106-107, (quoting Gypsum at 654).

The Kajima court stated that, "Although it is true that horizontal exhaustion originated in cases involving a continuous tort or long-term environmental and hazardous waste claims, we find no evidence that horizontal exhaustion is limited to such claims." Id. at 113.

In resolving the issue between targeted tender and horizontal exhaustion, the Kajima court stated, "We decline to extend the targeted tender doctrine to require one insurer to vertically exhaust its primary and excess coverage limits before all primary insurance available to the insured has been exhausted.

Extending the targeted tender rule to require an excess policy to pay before a primary policy would eviscerate the distinction between primary and excess insurance." Id. at 116.

In Padilla Const. Co. Inc. v. Transportation Ins. Co., 150 Cal.App.4th 984 (2007), the Court of Appeal, 4th District, Division 3 explained that horizontal exhaustion is the general rule applied in California: "California's rule of 'horizontal exhaustion' in liability insurance law requires all primary insurance to be exhausted before an excess insurer must 'drop down' to defend an insured, including cases of continuing loss." 986, (citing Community Redevelopment Agency v. Aetna Casualty & Surety Co., 50 Cal.App.4th 329).

The court noted one exception to that rule: "Unless there is an excess insurance that describes underlying insurance and promises to cover a claim when that specific underlying insurance is exhausted ('vertical exhaustion'), the rule of horizontal exhaustion applies to cases of alleged continuing property damage — as often happens when the insured is sued for construction defects." Community Redevelopment Agency, 50 Cal.App.4th at 340.

In Padilla, the court also explains that the Supreme Court of California adopted the "continuous injury trigger" in Montrose Chemical Corp. v. Admiral Ins. Co., 10 Cal.4th 645 (1995). This theory holds that each policy in effect over the period of years that the injury took place must provide coverage.

Therefore, a single claim that spans years, such as an asbestos exposure case, can obligate many different insurance companies to indemnify the insured.

Therefore, "all primary insurers over the time of the alleged continuous injury will be obligated to defend an underlying action claiming such continuous injury." Padilla, 150 Cal.App. 4th at 987.

The court goes on to state that the excess insurer does not have a duty to "drop down" and defend before the primary insurance is exhausted, even though the primary insurer does not have a duty to defend for damage that occurred before the primary policy began. Id. at 988.

Instead, the "lone primary insurer has a duty to 'defend entirely,' and so, from the point of view of the excess insurer, there was indeed 'other insurance' available — that is, other insurance to undertake the task of defending the insured." Id. at 988 (citing Buss v. Superior Court, 16 Cal.4th 35 (1997)).

"All right," you think, "I've got horizontal exhaustion covered. Now I need to understand vertical exhaustion." You remember some New Jersey case law you've read dealing with vertical exhaustion. You reach back into your research file for Owens-Illinois Inc. v. United Insurance Co., 138 N.J. 437 (1994).

Vertical Exhaustion

In Owens-Illinois, the Supreme Court of New Jersey adopted the continuous trigger theory of liability, stating that "when progressive indivisible injury or damage results from exposure to injurious conditions for which civil liability may be imposed, courts may reasonably treat the progressive injury or damage as an occurrence within each of the years of a CGL [comprehensive general liability] policy.

That is the continuous-trigger theory for activating the insurer's obligation to respond under the policies." Owens-Illinois, 138 N.J. at 478-79.

The court also looked to the policies to answer how best to allocate the obligations of the insurers, a review that resulted in the rejection of the joint-and-several allocation method. Id. at 468.

In looking beyond the policies, the court decided on vertical exhaustion, stating, "any allocation should be in proportion to the degree of the risks transferred or retained during the years of the exposure."

The court therefore decided to allocate "the losses among the carriers on the basis of the extent of the risk assumed, i.e. proration on the basis of the policy limits, multiplied by years of coverage." Id. at 475, citing Armstrong World Indus. Inc. v. Aetna Cas. & Sur. Co., 26 Cal.Rptr.2d 35 (1993)).

"Interesting," you think. "New Jersey cites a case from California, which uses horizontal exhaustion, to support New Jersey's use of vertical exhaustion."

Returning to the case you're reading, you note that the court declined to address the issue of excess insurance, stating, “We realize that many complexities encumber the solution that we suggest, as it does, proration by time and degree of risk assumed — for example, determining how primary and excess coverage is to be taken into account of the order in which policies are triggered. The parties did not focus on those issues.” Id. at 476.

Next, you pick up Carter-Wallace Inc. v. Admiral Ins. Co., 154 N.J. 312 (1998), in which the Supreme Court of New Jersey addressed excess insurance in the context of Owens-Illinois.

The Carter-Wallace court looked to Chemical Leaman Tank Lines Inc. v Aetna Casualty & Surety Co., 978 F.Supp. 589 (D.N.J. 1997), which stated “the Owens-Illinois method intentionally assigns a greater portion of indemnity costs to years in which greater amounts of insurance were purchased, based on the view that this measure of allocation is more consistent with the economic realities of risk retention and risk transfer.” Chemical Leaman, 978 F.Supp. at 605.

Thus, the Chemical Leaman court “rejected the horizontal exhaustion theory of horizontal exhaustion by layer, and ‘direct[ed] apportionment of damages among policy years without reference to the layering of policies in the triggered years.’” Carter-Wallace, 154 N.J. at 326, (quoting Chemical Leaman, 978 F.Supp. at 605). Therefore, the Carter-Wallace court adopted the Chemical Leaman approach.

The Court held that the Owens-Illinois methodology also applies in situations where both primary and excess insurance exist.

Now that you’re confident that you have the whole horizontal versus vertical exhaustion issue down pat, a voice in your head says, “Not so fast.” “Why not?” you ask. The voice replies, “You haven’t figured out which jurisdiction’s law will apply to your matter yet.” You think about the next set of colored squares on your Rubik’s Cube, choice of law, and head back to your research file yet again.

Yellow Squares: Choice of Law

You remember from your prior research that courts in the United States apply one of three basic choice of law doctrines, with slight permutations or variations depending on the jurisdiction. Of course, if the policy contains a choice of law provision, you head straight to the law of the jurisdiction designated in that provision.

Otherwise, you must examine the most significant contacts test (also known as the Restatement

(Second) approach), the place of the contract or lex loci contractus test, or the governmental interest analysis.

The majority rule is the most significant contacts test, or Restatement (Second) approach. It is followed in one form or another by an overwhelming number of jurisdictions. There are two main versions of this approach.

- One version springs from Section 188 of the Restatement (Second) of Conflicts of Laws, and holds that courts should ascertain the state with the most significant relationship to an issue by identifying and weighing potentially relevant contacts in light of general choice of law principles enumerated in Section 6 of the Restatement (Second). Gabe's Construction Company Inc., et al. v. United Capital Insurance Co., 539 N.W. 2d 144, 146 (Iowa 1995).

The contacts to be weighed include the place of the contracting, the place of negotiation of the contract, the place of performance, the location of the subject matter of the contract and the domicile, residence, nationality, place of incorporation and place of the business of the parties. Id.

Courts should evaluate these contacts according to their relative importance with respect to the particular issue. Id.

- The other version, which springs from Section 193 of the Restatement (Second) of Conflicts of Laws, holds that courts should apply the law of the state where the insured risk is principally located.

You read a New Jersey case, Gilbert Spruance v. Pennsylvania Manufacturers, 134 N.J. 96, 629 A.2d 885 (1993), in which the New Jersey Supreme Court held that in determining which choice of law rule will govern interpretation of casualty-insurance contracts, such as CGL policies, courts must look first to Section 193 of the Restatement (Second), which provides that the law of the state that the parties understood was the principal location of the insured risk will govern, unless some other state has a more significant relationship to the transaction and to the parties when measured under the principles set out in the Restatement (Second) at Section 6.

The Section 6 factors include the needs of the interstate and international systems, the relevant policies of the forum, the relevant policies of other interested states and the relative interests of those states in determining the particular issue, the protection of justified expectations, the basic policies underlying the particular field of law, certainty, predictability and uniformity of result and ease in the determination and application of the law to be applied. Restatement (Second) of Conflicts of Laws, Section 6.

Approximately a dozen states still use the place of the contract, or lex loci contractus approach. This rule results in courts applying the law of the state where the contract was executed, although some states interpret it to require application of the law of the state where the contract is performed.

You spot lex loci contractus cases in your file from Virginia and Maryland. "Virginia and Maryland," you think. "Must be a Mid-Atlantic thing."

In Lexie, et al. v. State Farm Mut. Auto. Ins. Co., 251 Va. 390, 469 S.E. 2d 61 (1996), the Supreme Court of Virginia held that, "[g]enerally, the nature, validity and interpretation of automobile insurance policies, like other contracts, are governed by the law of the place where made." Lexie, 251 Va. at 394.

In Continental Cas. Co. v. Kemper Ins. Co., 173 Md. App. 542, 920 A.2d 66 (2007), the Maryland Court of Special Appeals noted that, under Maryland law:

When interpreting insurance contracts, [courts] will apply the substantive law of the place where the contract was made, under the doctrine of lex loci contractus. Cooper v. Berkshire Life Ins. Co., 148 Md. App. 41, 55, 810 A.2d 1045 (2002).

"A contract is made in the place where the last act occurs necessary under the rules of the offer and acceptance to give the contract a binding effect." Id.

The locus contractu of an insurance policy is the state in which the policy is delivered and the premiums are paid. Aetna Cas. & Sur. Co. v. Souras, 78 Md. App. 71, 77, 552 A.2d 908 (1989).

Continental Cas. Co., 173 Md. App. at 548.

California appears to be the only state that uses the governmental interest analysis. However, you notice a 2007 case in your research file that calls into question whether California applies that doctrine to contract matters.

In Frontier Oil Co. v. RLI Ins. Co., 153 Cal. App. 4th 1436, 63 Cal. Rptr. 3rd 816 (2007), the Court of Appeal, Second District, Division 3 examined whether the governmental interest analysis or Cal. Civ. Code §1646 was the proper choice of law rule for contracts under California law. Under California's governmental interest analysis:

"[T]he court first determines whether the applicable rules of law of the potentially concerned jurisdictions are the same or different. If the applicable rules of law are identical, the court may apply California law.

"If the applicable rules of law differ materially, the court proceeds to the second step, which involves an examination of interests of each jurisdiction in having its own law applied to the particular dispute.

"If each jurisdiction has an interest in applying its own law to the issue, there is a 'true conflict' and the court must proceed to the third step.

"In the third step, known as the comparative interest analysis, the court determines which jurisdiction has a greater interest in the application of its own law to the issue, or, conversely, which jurisdiction's interest would be more significantly impaired if its law were not applied.

"The court must apply the law of the jurisdiction whose interest would be more significantly impaired if its law were not applied."

Frontier Oil Co., Cal. App. 4th at 1454-55.

Yet California has a statute on the books, Cal. Civ. Code §1646, that provides, "[a] contract is to be interpreted according to the law and usage of the place where it is to be performed; or, if it does not indicate a place of performance, according to the law and usage of the place where it is made."

The Frontier Oil Co. case noted that the Supreme Court of California has not addressed whether the governmental interest analysis or Section 1646 is the proper choice of law rule for contracts. As you read Frontier Oil Co., you note the court has thoroughly examined state and federal opinions that apply the governmental interest analysis or find the state of California law unclear on this point.

Nonetheless, the Frontier Oil Co. court concluded, "notwithstanding the application of governmental interest analysis to other choice-of-law issues, [Cal. Civ. Code] section 1646 is the choice-of-law rule that determines the law governing the interpretation of contracts." Frontier Oil Co., Cal. App. 4th at 1442-43.

"All right then," you think. "I'm ready to apply the appropriate choice of law analysis, whatever it is." Secretly, you hope it isn't California's.

Ready to Play?

You now have everything you need to tackle this coordination issue. At last you can start turning the squares on your Rubik's Cube.

You've sorted out your stack of policies, and you have identified the "other insurance" provisions in your policies. Does the provision limit the insurer's liability under that policy to its pro rata share of the loss? Then you've got a pro rata clause. Does it allow the insurer to provide no coverage if there is other available coverage under another policy? Then you've got an escape clause. Does it require exhaustion of all other available limits of insurance before it begins to pay? Then you've got an excess clause.

And, you now know the rules of how these types of "other insurance" provisions interact — excess trumps pro rata, and escape trumps them both. You also know whether conflicting escape clauses will be mutually repugnant, and maybe even nugatory.

Or maybe you will use the "total policy insuring intent" approach, and, because you cannot use the logic of the terms of the competing "other insurance" provisions, you will identify the insurer whose coverage was effected for the primary purpose of insuring the particular risk, making that insurer primarily liable for payment. One side of your cube is starting to look orange.

You have also identified the nature and level of coverage contained in each insuring agreement. Does the coverage grant depend on the exhaustion of an underlying liability policy? Then you've got a true excess policy. Does the coverage grant operate as excess because of the policy's excess "other insurance" provision? Then you've got a coincidental excess policy.

Happily, you know the practically universal rule that true excess is always excess over a policy providing primary coverage. Another side of your cube is starting to look purple.

Next, you have sorted out the timeline of effective periods for the various primary and excess policies in your stack. You need to pin down whether the applicable jurisdiction in your matter is like Illinois and California, which, using horizontal exhaustion, require all primary insurance to be exhausted over the course of the years of exposure before an excess policy can be triggered.

Or, is the jurisdiction like New Jersey, which, using vertical exhaustion, holds that an excess policy can be triggered if the primary policy immediately beneath it has been exhausted — even if other primary insurance exists? You think you see a blue side coming into focus.

Finally, you know you will review the policies for choice of law provisions. If there are no such provisions, you will likely employ one of the three prevailing choice of law doctrines, most significant contacts test, or Restatement (Second) approach, the place of the contract or lex loci contractus test or the governmental interest analysis.

You may have to set the governmental interest analysis to the side and use Cal. Civ. Code §1646. However it works out, the yellow side of your cube is coming into view.

Now, go out and solve that issue. Just make sure you don't let your client catch you playing with a Rubik's Cube during office hours.

--By James P. Steele and William J. Carter (pictured), Carr Maloney PC

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