

UNDERSTANDING THE “EXHAUSTION OF COVERAGE” DOCTRINE IN THE CONTEXT OF CONTINUOUS TRIGGER COVERAGE

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Excess insurance provides additional coverage beyond that provided by the underlying first layer of insurance, usually referred to as primary insurance policies. Excess insurance may, in turn, be layered with multiple layers of excess coverage. The combined, aggregate insurance policies are usually referred to as the “insured’s coverage program.” A fundamental issue with respect to the relationship between excess and underlying insurance is determining the event that triggers the specific excess coverage and brings it into play. Traditionally, the triggering event has been the “exhaustion” of the underlying insurance policy(ies), whether the underlying policy is primary or excess.

The Exhaustion requirement was initially developed when insurance coverage was siloed within distinct policy periods.¹ Siloing means there is a vertical tower of coverage, with layers of coverage, beginning with primary coverage² and extending upwards through one or multiple layers of excess coverage. Exhaustion envisions that as each underlying layer of coverage is used up, (i.e., the policy limits are expended (“exhausted”)), the next layer of coverage can be accessed. While this approach is not without problems, it has worked tolerably well as a means of regulating the relationship between insurers who provided underlying and overlaying levels of coverage within a single policy period.

The advent of continuous trigger coverage requires a reassessment of the relationship between underlying and overlaying insurers because siloing of coverage within a single policy period is no longer the norm.

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¹ Initially, courts simply referred to the exhaustion of “all primary coverage” before an insured could access overlaying excess coverage. *See, e.g., Olympic Ins. Co. v. Emp’rs Surplus Lines Ins. Co.*, 178 Cal. Rptr. 908, 912 (Cal. Ct. App. 1981). The term “horizontal exhaustion” seems to have first appeared in an Illinois Court of Appeal decision in 1994. *See United State Gypsum Co. v. Admiral Ins. Co.*, 643 N.E.2d 1226, 1261 (Ill. App. Ct. 1994) (distinguishing between “horizontal” and “vertical” exhaustion of underlying primary insurance coverage).

² Primary coverage refers to the first layer, often called the “working layer,” of coverage. Most claims against an insured are resolved within this first layer of coverage.

Rather, insurance coverage extends to losses than run across multiple policy periods.³ Insured losses can no longer be compartmentalized within a single policy period; rather, insurers (primary and excess) find that coverage is triggered whenever any portion of a loss can be deemed to have occurred in a policy period.⁴ The aggregation of coverage accomplished by the use of a continuous trigger led the California Supreme Court to characterize the resulting aggregation of coverage across multiple policy periods as “one

³ A continuous trigger means that an ongoing event, such as a pollutant contaminating underground water reservoirs, may trigger multiple policies that provide coverage during the contamination period. Courts applying a continuous trigger treat the injury attributable to the insured event as indivisible. *State v. Cont'l Ins. Co.*, 281 P.3d 1000 (Cal. 2012). If the injury can be confined to a particular policy period, courts do not apply a continuous trigger. *See, e.g., In re Silicone Implant Ins. Coverage Litig.*, 667 N.W.2d 405, 419 (Minn. 2003). *Cf. N. States Power Co. v. Fid. & Cas. Co. of N.Y.*, 523 N.W.2d 657, 662-63 (Minn. 1994) (adopting continuous trigger because of the “scientific complexity of the issues involved, the extended period of time over which damages may have occurred before discovery, and the number of parties potentially involved”), *and* RESTATEMENT OF THE LAW OF LIAB. INS. §44, cmt. b (AM. LAW INST., Tentative Draft No. 1, 2016) (“For liability claims involving divisible harm, courts generally will attempt to allocate among the policy periods according to the actual injury or harm that occurred during the policy period even if the total harm occurred over a long period of time.”).

⁴ Most jurisdictions, including California, use the “injury in fact” test to implement the continuous trigger. *See Montrose Chem. Corp. v. Admiral Ins. Co.*, 913 P.2d 878, 894 (Cal. 1995) (“Under an injury-in-fact trigger, coverage is first triggered at that point in time at which an actual injury can be shown, retrospectively, to have been first suffered. This rationale places the injury- in-fact somewhere between the exposure, which is considered the initiating cause of the disease or bodily injury, and the manifestation of symptoms, which, logically, is only possible when an injury already exists. In the context of continuous or progressively deteriorating injuries, the injury-in-fact trigger, like the continuous injury, affords coverage for continuing or progressive injuries occurring during successive policy periods subsequent to the established date of the initial injury-in-fact.” (citations omitted)).

giant ‘uber-policy’ with a coverage limit equal to the sum of all purchased insurance policies across the period of loss.”⁵

Treating policies within a continuous trigger period as an “Uber Policy” does not, however, directly address how overlaying policies should respond to a loss relative to the responsibility of an underlying policy, particularly that of primary insurers. In adopting the “continuous trigger” and “all sums stacking” approaches, the California Supreme Court did not address how coverages within the “uber-policy” should be sequenced. This is, however, a fundamentally important question because the “uber-policy” is an illusion if it cannot be effectively and efficiently accessed by the insured. As will be addressed in this paper, the sequencing of coverage provided by horizontal exhaustion results in the irony that the more coverage the insured purchases, the greater the likelihood much of the purchased insurance will not be available to pay claims put in coverage under the “continuous trigger” “all sums stacking” doctrines.

For the most part, insurers, as a group have argued for “horizontal” exhaustion to determine when overlaying coverages first become responsible for a loss. Horizontal exhaustion requires that all underlying layers of coverage be “exhausted” before an overlaying level of coverage must provide coverage.⁶ For example, look at Schematic 1, on page 266. Assume an insured event triggers the Alpha, Beta, and Gamma policies under a continuous trigger. Under the horizontal exhaustion test, Excess Insurer Omega would argue that all underlying insurance from primary insurers Alpha, Beta, and Gamma would have to be exhausted before Omega would have a coverage obligation. Thus, even if the underlying Gamma policy was exhausted, Omega would have no coverage obligation until the underlying Alpha and Beta policies were also exhausted. Under this approach, second layer excess Insurer Sigma would argue that it has no coverage obligations

⁵ State v. Continental Ins. Co., 281 P.3d 1000, 1008 (Cal. 2012). In this decision, the California Supreme Court used the term to describe the practical effect on insurers who provide coverage over a period of time to an insured who has sustained a progressive loss (e.g., environmental contamination) and coverage obligations are subject to both a “continuous trigger” and “all sums stacking.” The practical effect of adopting a “continuous trigger” and “all sums stacking” is that a loss that extends over several years separately triggers each year’s policies cumulatively. *Id.*

⁶ See., e.g., Emp’rs Ins. Co. of Wausau v. Granite State Ins. Co., 330 F.3d 1214, 1221 (9th Cir. 2003).

until all the underlying coverage provided by Primary Insurers Alpha, Beta, Gamma, and First Layer insurers Epsilon, Theta, and Omega was exhausted. Insurers often use the metaphor of a “rising tide” to illustrate the manner in which layers of coverage within an insured’s coverage program are accessed under the horizontal exhaustion approach.

Schematic 1

2d Layer, Excess Insurers	Psi	Sigma	Chi
1st Layer, Excess Insurers	Epsilon	Theta	Omega
Primary Layer, Insurers	Alpha	Beta	Gamma

Year 1 Policies Year 2 Policies Year 3 Policies

Policyholders, on the other hand, usually advance the argument of “vertical” exhaustion.⁷ Vertical exhaustion applies traditional siloing to continuous trigger coverage cases. Under vertical exhaustion, overlaying insurer coverage is only dependent on the exhaustion of the specific policy underlying the overlaying insurance policy. For example, under Schematic 1, using vertical exhaustion, once the underlying Gamma policy was exhausted, Omega’s excess policy would be triggered, even though neither the Alpha nor the Beta policies were exhausted.⁸ Vertical exhaustion is consistent with the traditional approach used when there is no continuous trigger. Each policy year is siloed (kept apart) from other policy years. Absent a continuous trigger, an insured event in year 2 would only trigger the Beta primary policy. The Alpha and Gamma policies would not be

⁷ *Montrose Chem. Corp. v. Superior Court*, 222 Cal. Rptr. 3d 748, 756 (Ct. App. 2017), *rev. granted* *Montrose Chem. Corp. v. S.C. (Canadian Universal Ins. Co.)* 406 P.3d 327 (Cal. 2017) (mem.).

⁸ *See, e.g., Outboard Marine Corp. v. Liberty Mut. Ins. Co.*, 670 N.E.2d 740, 748 (Ill. App. Ct. 1996). This approach is particularly helpful to insureds if coverage is uneven because horizontal exhaustion will preclude immediate access to coverage in policy years with more excess coverage until underlying coverage in other policy years (with possibly lesser coverage (in terms of policy limits)) is exhausted.

triggered. If the Beta policy was exhausted, only the Theta policy would respond, and the Sigma policy would only respond if the Theta policy was exhausted. None of the excess insurers in years 1 and 3 would have coverage obligations upon the exhaustion of the Beta policy, or any year 2 policies for that matter. If a continuous trigger is applied, under vertical exhaustion, once the Beta policy is exhausted, the Theta policy is triggered. This triggering occurs even though the Alpha and Gamma policies are not exhausted.

In this paper I explore a number of issues that relate to the selection of horizontal or vertical exhaustion in the context of a continuous trigger approach to coverage. The presence of one or more of these issues will ordinarily result in the inability to completely exhaust a successive layer of coverage, for example, the first layer of excess coverage shown on Schematic 1 across policy year 1 through 3. When this occurs, under the theory of horizontal exhaustion all overlaying policies anywhere in the coverage program will now escape any obligation to provide coverage. For example, if in Schematic 1 the Beta policy was not exhausted, under horizontal exhaustion all the overlaying excess insurers in the first and second excess layers of coverage for policy years 1-3 would escape coverage obligations. The consequence will be, if horizontal exhaustion is adopted, a cascading loss of coverage throughout all the towers of coverage from that point onward.

The first part of this paper addresses whether policy language generally calls for adoption of horizontal or vertical exhaustion. Should the selection of horizontal or vertical exhaustion be a rule or interpretation or a rule of construction, like the doctrine of construction against the drafter (*contra proferentem*)? If selection of the exhaustion rule is seen as one of the policy interpretations, what language should be understood as selecting one exhaustion approach over the other?

This paper next examines a number of doctrines that apply to the exhaustion issue in general.

These include:

First, should a settlement with an underlying insurer affect the obligations of higher layer insurers when they fail to exhaust policy limits?

Second, and related to Second, should non-accumulation and prior insurance provisions affect the exhaustion issue?

Third, should the insolvency of an underlying insurer affect the exhaustion issue?

Fourth, should loss allocation agreements between policyholders, such as indemnity and hold harmless agreements, affect the exhaustion issue?

This paper concludes with an argument that when courts impose coverage obligations under a “continuous trigger” “all sums stacking” approach the obligations of underlying and overlaying insurers, whose policies are triggered by the “continuous trigger” theory, should be determined under a vertical rather than horizontal exhaustion approach. Adoption of horizontal exhaustion is not only inconsistent with the concept of the “giant uber-policy”, adoption of horizontal exhaustion puts of the insured’s entire coverage program at risk whenever any part of the program fails.

I. JUSTIFICATION FOR HORIZONTAL OR VERTICAL EXHAUSTION BASED ON POLICY LANGUAGE

Courts justify the application of either horizontal exhaustion or vertical exhaustion on two grounds: policy language and public policy; however, in this context the differences between the two grounds are not always well defined. Moreover, courts have not always been consistent in the treatment of policy language as supporting horizontal as opposed to vertical exhaustion.

Some, but not all, courts have adopted vertical exhaustion when an overlaying level of coverage specifically identifies an underlying policy which has been exhausted. For example, in *Viking Pump* the New York Court of Appeals held that vertical exhaustion was called for when the overlaying policy referenced underlying policies as those “listed as an underlying policy in the declarations.”⁹ In that context, the overlaying policy was triggered upon the exhaustion of the described referenced policies without regard to the status of the other policies at the same layer of any of the referenced policies.

Similarly, in *State v. Continental Insurance Co.*, the appellate court stated that language in an excess insurance policy that liability attached upon an “Ultimate Net Loss” which referenced the specified retention “seems to be the very definition of vertical exhaustion.”¹⁰

On the other hand, language that states the overlaying coverage is excess of [referenced policies] “and any other underlying insurance

⁹ *In re Viking Pump*, 52 N.E.3d 1144,1157 (N.Y. 2016).

¹⁰ 223 Cal. Rptr. 3d 716, 727 (Ct. App. 2017).

providing coverage to the insured” has been interpreted as calling for horizontal exhaustion.¹¹

In *Montrose Chemical Corp.*, the court held that overlaying coverage that referenced specific coverage required horizontal exhaustion when the policy language specifically referenced a provision that incorporated “other underlying insurance.”¹² The policy language, as restated by the court, provided:

[T]he insurer agrees to pay on behalf of the insured the ultimate net loss in excess of the retained limit hereinafter stated.” The declarations then identify the underlying policies to which the American Centennial policies are specifically in excess (the “scheduled policies”).¹³

The court noted the “Retained Limit” clause referred to the overlaying insurer’s liability as “excess of the identified underlying insurance and the applicable limits of any other underlying insurance collectible by the insured.”¹⁴ While the court could have treated the conflicting language as ambiguous and resolved the conflict in the insured’s favor,¹⁵ the court chose to emphasize the broader language in the Retained

¹¹ *Montrose Chem. Corp.*, 222 Cal. Rptr. 3d at 763 (discussing the American Centennial excess policies).

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.* at 764 (“The ‘retained limit’ clause: This clause provides: ‘[T]he company’s liability shall be only for the Ultimate net loss in excess of the insured’s retained limit defined as the greater of: [...the total of the applicable limits of the underlying policies listed in the [declarations] hereof, and applicable limits of any other underlying insurance collectible by the insured.’ (italics added.) This clause thus expressly states that the excess insurer’s liability is in excess of the identified insurance and the applicable limits of any other underlying insurance collectible by the insured.”).

¹⁵ This is the rule of *Contra Proferentum*, or construction against the drafter. Often, but not always, courts will find that an inconsistency between insurance provisions in the same policy create ambiguity. That ambiguity is then resolved in the favor of the policyholder if a reasonable interpretation of the ambiguity so permits.

Limits clause as supporting horizontal exhaustion because of the general reference to “other underlying insurance.”¹⁶

The *Montrose Chemical Corp.* also found support for adoption of horizontal exhaustion when the overlaying policy references specific underlying coverage by looking at the overlaying policy’s “Other Insurance” clause, which provided that the overlaying policy was excess to “both scheduled and unscheduled policies.”¹⁷ However, this use of the “Other Insurance” clause language to support horizontal exclusion has been rejected by other courts as improper for several reasons. First, “Other Insurance” clauses are seen by these courts as a means of allocating responsibility for a loss among insurers, not as a means of avoiding or deflecting liability to an insured.¹⁸ When the “continuous trigger” and “all sums stacking” approach is adopted, the insured’s entire coverage program is available to provide compensation for the loss. Allowing insurers to use the “Other Insurance” provision to escape or deflect their coverage obligations for a loss sustained by their common insured is inconsistent with the view that “Other Insurance” provisions are intended to prevent payments to the insured in excess of the

¹⁶ *Montrose Chem. Corp.*, 222 Cal. Rptr. 3d at 764 (italics in the original).

¹⁷ *Id.* (“The ‘other insurance’ clause : This clause states: “ ‘If other collectible insurance...is available to the insured covering a loss also covered hereunder (except insurance purchased to apply in excess of the sum of the retained limit and the limit of liability hereunder) the insurance hereunder shall be in excess of and not contribute with, such other insurance.’ ” This clause thus provides that the American Centennial policies are excess to both *scheduled* and *unscheduled* policies.)

¹⁸ See, e.g., *Continental Ins. Co.*, *supra* note 5, 223 Cal. Rptr. 3d at 727 (collecting California decisions); *cf.* *Shade Foods, Inc. v. Innovative Product Sales & Marketing, Inc.*, 93 Cal. Rptr.2d 364, 407 (Ct. App. 2000):

The other-insurance clause, as we have seen, does not excuse the insurer from discharging its independent obligation to indemnify the insured up to policy limits, though it gives the insurer a right to an adjudication allocating the indemnity obligation between it and the other insurer.

The court added that the insurer’s use of the “Other Insurance” clause to deflect its obligations will support a jury’s determination of ‘bad faith.’”

loss, consistent with the principle of indemnity.¹⁹ When the “Other Insurance” clause purports to require exhaustion of other available insurance before the policy may be accessed, the “Other Insurance” clause is typically referred to as an “excess” or “escape” type provision. “Escape” and “Excess” type provisions create difficulties because the other available insurance policy(ies) may also have “escape” or “excess” type “Other Insurance” clauses, which results in mutual repugnancy.²⁰

Second, and more generally accepted, many courts limit the use of “Other Insurance” clauses to insurers providing the same layer or level of coverage.²¹ Using the “Other Insurance” clause as a justification for horizontal exclusion is not consistent with this limitation because horizontal exhaustion requires exhaustion of underlying layers of coverage, which are clearly not at the same layer or level of coverage as the policy containing the “Other Insurance” clause.²² Courts relying on the “other Insurance” clause

¹⁹ See ROBERT E. KEETON, ALAN I. WIDISS & JAMES M. FISCHER, *INSURANCE LAW* § 3.11, at 217 (2d ed. 2016) (“Duplication of coverage raises the prospect that the indemnity principle will be violated. Other Insurance Provisions seek to ameliorate duplicate coverage so that indemnity principle is preserved.”) (footnote omitted).

²⁰ *Dart Indus., Inc. v. Commercial Union Ins. Co.*, 52 P.3d 79, 93 (Cal. 2002) (“[P]ublic policy disfavors ‘escape’ clauses, whereby coverage purports to evaporate in the presence of other insurance. This disfavor should also apply, to a lesser extent, to excess-only clauses, by which carriers seek exculpation whenever the loss falls within another carrier’s policy limit.”)

²¹ *In re Viking Pump*, 52 N.E.3d 1144, 1157 (N.Y. 2016) (“[W]e stated in *Consolidated Edison* that ‘other insurance’ clauses’ apply when two or more policies provide coverage during the same period, and they serve to prevent multiple recoveries from such policies, “and that such clauses ‘have nothing to do’ with whether any coverage potentially exist[s] at all among certain high-level policies that were in force during successive years.”)(citation omitted).

²² See KEETON, WIDISS & FISCHER, *supra* note 19, at 220. See also *Dart Indus., Inc. v. Commercial Union Ins. Co.*, 52 P.3d 79, 93 (Cal. 2002) (“[H]istorically, ‘other insurance’ clauses were designed to prevent multiple recoveries when more than one policy provided coverage for a particular loss. On the other hand, ‘other insurance’ clauses that attempt to shift the burden away from one primary insurer wholly or largely to other insurers have been the objects of judicial distrust. Public policy disfavors

as supporting the adoption of horizontal exhaustion have not explained affirmatively why the “Other Insurance” clause should be applied to different layers of insurance.²³

Many courts have stated that a particular form of exhaustion is required based on precedent.²⁴ This argument, however, begs the question as to why the initial decision that constitutes the precedent was made in the first place. Horizontal exhaustion has been justified as consistent with the price differential between primary and excess coverage.²⁵ This appears, however, to more an assertion than a justification. Price reflects the actuarial assessment that the covered risk will occur. Unless we know the underlying actuarial assessments, we cannot determine what the price specifically envisions as to risk.²⁶ Some courts have justified adoption of horizontal exhaustion as necessary to prevent insureds from manipulating the sources of recovery and ignoring the distinctions between primary and excess insurance.²⁷ Again, these appear to be more in the nature of assertions rather than reasoned arguments as courts making these arguments have not identified instances of manipulation nor reasons why horizontal exhaustion

escape clauses, whereby coverage purports to evaporate in the presence of other insurance. This disfavor should also apply to a lesser extent, to excess-only clauses, by which carriers seek exculpation whenever the loss falls within another carrier’s policy limit. Partly for this reason, the modern trend is to require equitable contributions on a pro rate basis from all primary insurers regardless of the type of ‘other insurance’ clause in their policies.”(citations omitted)).

²³ *E.g., Montrose Chem. Corp. v. Superior Court*, 222 Cal. Rptr. 3d 748, 767 (Ct. App. 2017) (distinguishing a prior decision that contained language that “Other Insurance” clauses only applied to allocations among insurers and should not be used to deflect insurer coverage obligations). Distinguishing a prior decision is not, however, the same as affirmatively demonstrating the soundness of the position reached.

²⁴ *See Iolab Corp. v. Seaboard Sur. Co.*, 15 F.3d 1500, 1504 (9th Cir. 1994).

²⁵ *See Mo. Pac. R.R. Co. v. Int’l Ins. Co.*, 679 N.E.2d 801, 809 (Ill. Ct. App. 1997).

²⁶ Applying horizontal exhaustion to primary layers of coverage may be justified because of the defense obligation that attaches at the primary level and which is reflected in the risk assumed by primary insurers. *See infra* notes 43-48 and accompanying text.

²⁷ *See, e.g., U.S. Gypsum Co. v. Admiral Ins. Co.*, 643 N.E.2d 1226, 1261 (Ill. Ct. App. 1994).

is more congruent with the primary-excess distinction than vertical exhaustion.

The claim has been made that vertical exhaustion should be adopted because it is most consistent with the “All Sums” method of allocation that has been adopted by most jurisdictions to address coverage obligations under the continuous trigger doctrine.²⁸ While courts have not explained why vertical exhaustion is most consistent with the “All Sums” approach,²⁹ an explanation may lie in the third reason courts have given for adopting a particular exhaustion approach for reasons other than policy language. That reason is complexity. It becomes exceedingly difficult to determine how overlaying coverage should be accessed when the insurance plan extends over a lengthy period of time, and the doctrine in the jurisdiction holds all that policies have been triggered – creating the so-called “Uber” policy.³⁰ Consider for example the problem of uneven layers of insurance described in Schematic 2, on page 274, where some policy periods have 7 layers of coverage; other policy periods have 5 layers of coverage, etc. More importantly, the layers of coverage have different limits. For example, in year 3, Insurer J has \$19 million of coverage over an underlying primary layer, provided by Insurer L, of \$1 million. In year 5, two successive insurers,

²⁸ See *Viking Pump*, 52 N.E.3d at 1156 (collecting decisions); see also RESTATEMENT OF THE LAW OF LIAB. INS., §§ 42 cmt. c, 44 cmt. c (Proposed Final Draft 2017).

²⁹ In some respects, the problem may be one of framing. For example, in Schematic 1, should the insurance provided by the nine insurers be seen as coverage (singular) or as coverages (plural)? If the entire program of insurance is seen as an integrated package of insurance (the “uber” policy), it may be easier to visualize coverage as rising evenly from bottom to top (horizontal exhaustion) than spiking as individual coverages are exhausted (vertical exhaustion).

³⁰ Courts that adopt horizontal exhaustion tend to put this concern in the “never mind” category. See *Montrose Chem. Corp.*, 22 Cal. Rptr.3d at 1335-36 (“Montrose argues finally that mandatory horizontal exhaustion is ‘unworkable in practice’ because of the complexity of its coverage portfolio. We do not doubt that allocating more than \$200 million in liability across more than 100 policies covering nearly 25 years is likely to be a complicated process. The complexity, however, is not relevant to our analysis, as we cannot, in the service of expediency, impose obligations that are inconsistent with the terms of the contracts Montrose itself negotiated.”).

Insurers S and T, provided the same amount of coverage over an underlying layer of coverage, provided by Insurer R. How would Insurer S and T’s obligations be triggered? Is Insurer T a second layer or third layer insurer for purposes of horizontal exhaustion? If overlaying policies are simply triggered as underlying dollar amounts, e.g., \$1 million, \$5 million, \$10 million, etc. are reached, the internal structure of coverage within each policy year is compromised. If each layer within a policy period must await the exhaustion of the underlying layer, regardless of total losses within the triggered policy periods, the metaphor of a rising tide is an illusion.³¹

Schematic 2

\$50 Million				\$50 Million			
\$40 Million				Insurer P		Insurer CC	\$40 Million
\$30 Million					Insurer U	Insurer BB	\$30 Million
\$20 Million		Insurer H	Insurer K			Insurer AA	\$20 Million
\$15 Million	Insurer D	Insurer G		Insurer O	Insurer T	Insurer Z	\$15 Million
\$10 Million						Insurer Y	\$10 Million
\$5 Million	Insurer C			Insurer N	Insurer S	Insurer X	\$5 Million
\$1 Million	Insurer B	Insurer F	Insurer J	Insurer W		\$1 Million	
	Insurer A	Insurer E	Insurer L	Insurer M	Insurer R	Insurer V	
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	

Another problem with implementing horizontal exhaustion is that policy limits within the various layers of the insured’s coverage program may be uneven from year to year. For example, in year 1, the 4th layer of

³¹ Another example of this concern is provided by *Westport Ins. Corp. v. Appleton Papers, Inc.* 787 N.W. 2d 894, 918-19 (Wis. Ct. App. 2010).

coverage provided by Insurer D attaches at \$10 million; in year 4 the 4th layer of coverage attaches at \$40 million. Similarly, in years 1, 2, 3, 5, and 6, the primary layer provides \$1 million in coverage, but in year 4, the coverage provided by Insurer M is \$5 million. Rather than coverage being distributed evenly by layer and amount through the 6-year coverage period, insurance coverage is unevenly distributed both as to the number of layers of coverage, the amounts of insurance coverage provided in the individual policies, and the aggregate amount of insurance provided in each policy year. Exhausting underlying coverage horizontally across uneven towers of coverage can prove to be a daunting task.³²

A second reason for rejecting horizontal exhaustion on policy ground is that it contains a disguised forfeiture feature: The more coverage an insured purchases, the greater the risk much of the coverage will be lost due to the inability to fully exhaust one of the policies in the coverage program.

Consider for example, the coverage program set out in Schematic 2. If the insured only purchases coverage for year 1, the year 1 coverage is defined by the coverages provided by Insurers A, B, C, and D. If, however, the insured acquires coverage in year 2, the insured’s ability to access the coverage provided by Insurers B, C, and D is now controlled by the need to exhaust the coverages provided by Insurers E, F, G, and H. The problem continues as the insured continues the coverage program into year 6. Now the coverage provided by Insurers B, C, and D is subject to being lost if the insured does not fully exhaust the coverage provided by Insurers V, W, X, Y, Z, etc. Under the horizontal exhaustion approach the failure to exhaust the policy coverage provided by Insurer V puts all of the coverage for all of the years at risk. That is a forfeiture, plain and simple. There is no sound reason why coverage in place (e.g., year 1) should be subject to subsequent events (e.g., coverage placed in year 6). Courts that have adopted horizontal exhaustion have assumed all they are resolving is how the sequencing of policies in place will be accessed. These courts have ignored, or failed to fully consider, the significant likelihood that a policy will not be exhausted and how that failure will affect the insured’s ability to access other triggered policies. And as shown in Parts II through V of this paper, the likelihood that

³² Insurance towers of coverage may be extensive. Appendix A to this illustrates the insurance coverage program of an insured that was involved in coverage litigation involving a toxic waste site. *See State v. Cont’l Ins. Co.*, 15 Cal. App. 5th 1017, 1047-48 (Cal. Ct. App. 2017).

a policy in the insured's coverage program will not be fully exhausted is a real and present danger. In effect, the horizontal exhaustion doctrine operates as a hidden bomb that when detonated by the inability to exhaust a single policy, compromised the entire coverage program.³³ Horizontal exhaustion kills coverage while preserving the illusion of coverage. The unappreciated consequence of horizontal exhaustion is that the more coverage an insured obtains, the less likely it becomes that the insurance purchased will be available to the insured when a loss occurs.

II. SETTLEMENT AND EXHAUSTION OF UNDERLYING LIMITS

A recurring issue today is the effect of a settlement between an insured and an underlying insurer on the overlaying insurer when the settlement is for less than the underlying insurer's policy limits. For example, in Schematic 2, assume Insurer M, with \$5 million in limits, disputes coverage of the claim and the Insured and Insurer M agree to settle the dispute with a payment by Insurer M of \$4 million. What affect, if any, does the settlement have on the coverage obligations of Insurers A through CC?

When an insured settles a coverage dispute with an underlying insurer for less than the policy limits, overlaying insurers will claim that a condition of their coverage obligations – exhaustion by payment of policy limits of underlying coverage – has not been met. Excess insurers will also claim that payment or credit by the insured of any difference between the settlement amount and the policy limits will not satisfy the coverage condition in the overlaying policy, absent express policy language permitting the insured to cover.

Not surprisingly, courts have differed whether the excess insurers' position should be accepted. Many decisions today adopt a formal "follow the policy language" approach. Under this approach, the policy language determines whether the insured may access the excess insurance coverage by covering the gap between the settlement amount and the policy

³³ Forfeiture of policy benefits is disfavored, and courts will generally construe policy terms and adopt rules of policy construction that avoid forfeiture of policy benefits. *See* COUCH ON INSURANCE §§ 22:34-35 (3d ed. 2017). *See also* *Richmond v. Dart Indus, Inc.*, Cal 629 P.2d 23, where the California Supreme Court comments that coverage escapism by insurer use of "Other Insurance" clauses is disfavored. *See supra* note 20. The same sentiments apply to coverage escapism produced by horizontal exhaustion.

limits.³⁴ As, however, with almost all insurance claims, disputes may arise whether the policy language does permit the insured to access an overlaying level of coverage by paying the differences between the policy limits and the settlement amount.

Consider, for example, policy language that simply requires exhaustion of an underlying policy by “actual payment.” Must the payment be made by the insurer in satisfaction of judgment or settlement, or may it be made by the insured? Again, courts have disagreed on this point.³⁵

When relying exclusively on policy language, very slight differences in policy language may result in a loss or preservation of excess insurance coverage when an insured settles a coverage dispute with an underlying insurer for less than the policy limits. For example, in *Zeig v. Massachusetts Bonding & Ins. Co.*,³⁶ the court held that language in an excess insurance policy that conditioned access when the underlying policy was “exhausted in the payment of claims to the full amount of the expressed limits” permitted the insured to satisfy the requirement by a bridge payment.³⁷ In *Ali v. Federal*

³⁴ In some situation, the policy language explicitly permits the insured to cover the gap. See, e.g., Axis Excess D & O Policy, XS 0001 12 10:

This policy shall provide insurance excess of the Underlying Insurance. Liability shall attach to the Insurer only after (i) the Insurers of the Underlying Insurance, the Insureds or others on behalf of the Insureds shall have paid in legal currency amounts covered under the respective Underlying Insurance equal to the full amount of the Underlying Limit...

³⁵ *Cf.* *Forest Labs. Inc. v. Arch Ins. Co.*, 953 N.Y.S. 2d 460 (N.Y. Sup. Ct. 2012) (holding that “actual payment” language unambiguously requires payment by insurer to exhaust limits); *with* *Maximus, Inc. v. Twin City Fire Ins. Co.*, 856 F. Supp. 2d 797 (E.D. Va. 2012) (holding that “actual payment” language was ambiguous and could be reasonably construed to permit bridging payment by insured to satisfy exhaustion requirement). By “bridging payment” I mean that the insured assumes the obligation to pay the difference between the policy limits and the amount of the settlement.

³⁶ *Zeig v. Mass. Bonding & Ins. Co.*, 23 F. 2d 665 (2d Cir. 1928).

³⁷ *Id.* at 666. *Zeig* involved a 1st party property insurance policy, which did not contain a duty to defend. A number of courts have distinguished *Zeig* on this ground and have refused to apply *Zeig* to 3d party liability insurance

Ins. Co., however, the court held that language in the excess insurance policy that conditioned access to the policy “only after...all Underlying Insurance has been exhausted by payment of claims...solely as a result of payment of losses thereunder” did not permit the insured to use a bridge payment to satisfy the condition of access to the excess insurance policy.³⁸

In many cases today, the policy language is quite clear that exhaustion must be accomplished by payments by the insurer.³⁹ Of course, a consequence of treating payment by the insurer as the exclusive method of exhausting underlying coverage is that the insured loses overlaying insurance by settling a coverage dispute with the underlying insurer. A number of courts and commentators have argued that such a result imposes a forfeiture on the insured that is violative of public policy. Under this view, when the insured in good faith settles a coverage dispute with the underlying insurer for less than policy limits, that settlement should not cause the insured to lose the excess insurance in place when the overlaying insurers are not prejudiced.⁴⁰ Alternatively, if the dispute is not resolved and the insurer prevails on the coverage dispute, that specific policy in the tower of coverage is not exhausted and, under the horizontal exhaustion approach, the entire coverage program collapses from that point upward.

The problem is compounded in the continuous trigger context when the issue is whether the court should apply either horizontal exhaustion or vertical exhaustion. If vertical exhaustion is adopted and an “insurer-only” payment requirement is enforced, the insured’s coverage losses are limited to the policy period in which the particular underlying policy is situated. For

coverages, such as the involved in most cases where the “continuous trigger” “all sums stacking” approach is applied. See text and notes 40-46, where the issue of horizontal exhaustion in the duty to defend context is discussed.

³⁸ *Ali v. Federal Ins. Co.*, 719 F. 3d 83 (2d Cir. 2013).

³⁹ See, e.g., *Qualcomm, Inc. v. Certain Underwriters at Lloyd’s, London*, 73 Cal. Rptr. 3d 770 (4 Cir. 2008). The policy provided: “Underwriters shall be liable *only after* the insurers under each of the Underlying policies *have paid or have been held liable to pay the full amount* of the Underlying Limit of Liability.” *Id.* at 778. The court held that the policy language did not permit the insured to make a bridging payment to allow access to the excess insurance coverage. *Id.* at 774-75.

⁴⁰ See generally Jeffrey W. Stemple, *An Analytical “Gap”: The Perils of Relentless Enforcement of Payment-by-Underlying-Insurer-Only Language in Excess Insurance Policies*, 52 TORT TRIAL & INS. PRAC. L.J. 807, 863 (2017) (criticizing judicial willingness to enforce “insurer-only” payment language as unfair to insureds and as unduly protective of insurers).

example, in Schematic 2, if the insured settled a coverage dispute with Insurer A for less than policy limits, the immediate consequences would be limited to year 1 coverages if only the coverages in place for that policy year are in play. If horizontal exhaustion is required, the consequences of the settlement may now spread into years 2 through 6. The insurers providing overlaying coverage in years 2 through 6 can now claim that their coverages are not triggered because *all* underlying insurance has not been exhausted by the payment of policy limits. Thus, not only does the tower of coverage in the specific policy period collapse, but application of horizontal exhaustion results in the entire insurance program, covering all the triggered policies, collapsing.

There is no substantial reason to permit the insurers in years 2 through 6 to withhold coverage based upon the resolution of a year 1 coverage dispute. Insurers B through D may be seen to have contracted that their obligations would be conditioned on the full performance by Insurer A of its obligations. That concession cannot be comfortably extended to the years 2 through 6 insurers except through a very generous reading of “Other Insurance” or similar provisions that may generally reference other underlying policies. Allowing the year 2 through 6 insurers to claim the settlement as a defense to payment by them renders the “uber” policy illusory. Similarly, horizontal exhaustion allows insurers B through D to defer their coverage obligations until exhaustion of underlying coverage in years 2 through 6, coverage that was not in existence at the time insurers B through D placed their coverage. There is no reason why Insurers B through D should be allowed to escape their coverage obligations based on coverages obtained by their insured after the B through D policies were obtained. Surely such actions by the insured are completely fortuitous to the decision by insurers B through D to provide coverage to the insured. Any settlement by an insured of a coverage dispute with one insurer would require the unanimous consent of all insurers whose policies have been triggered by the insured event to not treat the settlement as affecting other coverages. And because refusal to consent would preserve a complete coverage defense, every overlaying insurer would be incentivized to withhold consent.

Horizontal exclusion would in this context provide a windfall to insurers that cannot be justified by any underwriting or policy

considerations.⁴¹ A good faith settlement between the insured and an insurer promotes the efficient resolution of disputes and is consistently recognized as a desirable goal of civil adjudication. Therefore, to the extent courts would recognize and enforce “insurer-only” payment requirements, courts should not impose a horizontal exhaustion requirement, particularly in the continuous trigger, successive coverage context where doing so would allow *all* overlaying insurers to escape coverage obligations based on a single failure to pay policy limits by any single underlying insurer.

One consideration might, however, militate in favor of allowing overlaying insurers to withhold coverage when an underlying insurer has failed to completely exhaust its policy limits. This occurs when the underlying insurer has defense obligations, the cost of which are not credited against policy limits.⁴² In such a case, overlaying insurer may claim they have bargained for two layers of protection, (1) an indemnity protection based on policy limits, and (2) an unlimited defense obligation until the policy limits have been exhausted.

In the usual case, an overlaying insurer reasonably expects that defense costs will be borne by the underlying insurer until the underlying

⁴¹ See *Carter-Wallace, Inc. v. Admiral Ins. Co.*, 718 A.2d 1116, 1123 (N.J. 1998) (rejecting insurer proposed horizontal exhaustion in continuous trigger, successive coverage context).

⁴² In liability coverages defense costs are traditionally paid pursuant to the Supplemental Payments provision of the policy and are not charged against the policy’s indemnity limits. See KEETON, WIDISS & FISCHER, *INSURANCE LAW* § 8.1(e), at 790 (2d ed. 2016). The major exception to this principle occurs with respect to professional liability coverages where all or a portion of the insurer’s cost of defending the insured may be offset against the insurer’s indemnity obligation. *Id.* at n.51; see generally JERRY & RICHMOND, *UNDERSTANDING INSURANCE LAW* § 111[K] (4th ed. 2017). Defense costs can be substantial. See, e.g., *Biomass One, L.P., v. Imperial Cas. & Indem. Co.*, 968 F.2d 1220 (9th Cir. 1992) (Table) (noting that in defending policy’s indemnity limits of \$2 million, defense costs of \$1.9 million had been incurred); *Montgomery Ward & Co., Inc. v. Imperial Cas. & Indem. Co.*, 97 Cal. Rptr. 2d 44, 46-47 (2nd Cir. 2000) (noting several instances where defense costs associated with the defense of specific contamination claims exceeded indemnity limits by a factor of approximately 2.5, e.g., policy limits of \$1 million and defense costs in excess of \$2 million; moreover, in each case the defense costs substantially exceeded the indemnity costs actually paid, in two of the instances by a factor of ten).

policy is exhausted by payment of judgments and settlements. A within limits settlement of a coverage dispute between the insured and an underlying insurer effectively denies the overlaying insurer this measure of protection. And, as many courts have noted, the presence of a defense obligation correlates with the price differential between underlying (primary, or working, layer of coverage) and overlaying coverages.⁴³ Allowing an underlying insurer to escape its defense obligations may be seen as unfair to the overlaying insurer, which has relied on the underlying policy’s defense obligation in pricing the overlaying policy. Simply allowing the insured to pay (or credit) the difference between the indemnity limits and the amount actually received from the underlying insurer does not fully make the overlaying insurer whole because that payment (or credit) does not reflect defense payments that would have been borne by the underlying insurer until the indemnity limits were, in fact, fully exhausted by payment of judgments or settlements. This consideration is limited to defense costs and does not extend to indemnity obligations that accrue as a result of settlement or judgment.

The proposed Restatement addresses this issue in a slightly different manner. It notes that the premium charged by overlaying insurers may be based on the expectation that underlying insurers will more competently evaluate and resolve claims using policy money than will insureds using their own money.⁴⁴ But this distinction between insurer and insured acumen amounts to little if does not encompass the defense obligation, which is generally unlimited and not tied to the policy limits. A rational overlaying insurer may reasonably expect the great majority of claims to be resolved within the policy limits as long as defense costs are excluded from the

⁴³ See, e.g., *Ali v. Fed. Ins. Co.*, 719 F.3d 83, 91 (2d Cir. 2013) (quoting *Gabarick v. Laurin Mar. (Am.), Inc.*, 649 F.3d 417, 422 (5th Cir. 2011)); See also *Zurich Ins. Co. v. The Heil Co.*, 815 F.2d 1122, 1126 (7th Cir. 1987); See also *Maricopa Cty. v. Fed. Ins. Co.*, 157 Ariz. 308, 310 (Ariz. Ct. App. 1988).

⁴⁴ RESTATEMENT OF THE LAW OF LIA. INS. §42 cmt. d (AM. LAW INST., Tentative Draft No. 1, 2016). The reasoning behind the Restatement’s position is debatable. One would think insureds would be as careful with their money as insurers are with their money in the contexts where the “continuous trigger” is most often used – mass torts implicating large, sophisticated insureds who often have risk professionals and platoons of lawyers to advise them.

calculation. This expectation is reflected in the cost differential between primary and excess insurance⁴⁵ and the value consistently recognized by courts and commentators that the insurer's defense obligation provides insureds.⁴⁶

While the costs of the defense clearly affect the pricing of primary and excess coverages, it would be a mistake to place too much emphasis on that fact in the "continuous trigger" "all sums stacking" context. When coverage involves only a single policy period (concurrent coverage), an overlaying excess insurer has a legitimate interest in the assumption of defenses cost by the underlying insurer providing primary coverage. Whether that duty is discharged by the primary insurer or the insured should be irrelevant, unless the overlaying insurer can demonstrate actual prejudice

⁴⁵ For example, in *Schmitz v. Great Am. Assur. Co.*, 337 S.W.3d 700 (Mo. 2011), the court noted that the primary policy (with \$1 million policy limits) cost \$8,386, while the excess policy (with \$4 million policy limits) cost \$4,000.

⁴⁶ *See, e.g.*, *Montrose Chem. Corp. v. Superior Court*, 6 Cal. 4th 287, 295-96 (Cal. 1993) ("The insured's desire to secure the right to call on the insurer's superior resources for the defense of third party claims is, in all likelihood, typically as significant a motive for the purchase of insurance as is the wish to obtain indemnity for possible liability. As a consequence, California courts have been consistently solicitous of insureds' expectations on this score."); Eileen B Eglin & Stephen D. Straus, *Classifying RI/FS Costs under a Policy of Comprehensive General Liability Insurance or Defense*, 5 FORDHAM ENVTL. L. REV., 385 at 387 (2011) ("Depending upon the policy language, defense costs will either count towards the stated coverage limit of the policy or they will be exclusive of the limit. Under a cost-exclusive policy, the insurer's coverage obligation has the potential to be far greater than the stated indemnity limit. This is because defense costs in a cost-exclusive policy will not serve to impair the liability limit; only payments for damages in the form of judgments or settlements impair or exhaust the limits of a cost-exclusive policy. Defense costs under a cost-exclusive CGL policy can eclipse the stated policy limit where no settlements or judgements equaling the limits are sustained."); *See also* KENNETH S. ABRAHAM & DANIEL SCHWARCZ, *INSURANCE LAW AND REGULATION* 577 (6th ed. 2015) ("Most primary liability insurance policies not only provide indemnity to the insured; they also provide the right to a defense of all claims alleging liability that would be covered by the policy if the allegations were true. This coverage provides important 'litigation insurance,' since the costs of defending against even unsuccessful lawsuits can be substantial.")

if the defense is maintained by the primary insurer or the insured. In the “continuous trigger” context, however, the loss of a primary policy with a defense obligation, does not affect the obligation of other primary insurers to provide a defense. Courts has consistently recognized the primacy of the duty to defend in this context; therefore, any and all insurers in the “continuous trigger” context, whose policies contain a defense obligation, must provide a defense if their policy is triggered. Thus, failure of a primary insurer to provide a defense is unlikely to have an impact on an overlaying insurer because a complete defense will be provided by the other primary insurers. Permitting an overlying insurer to escape its indemnity obligations because one or even several underlying insurers failed to provide a defense would be a complete exaltation of form over substance in the “continuous trigger” context.

Some courts have suggested that concern over collusion between an insured and an underlying insurer is an independent justification for requiring actual payment of indemnity limits by an insurer to exhaust the policy. For example, in *Ali v. Federal Insurance Company* the court distinguished *Zeig v. Massachusetts Bonding & Insurance Company* on the ground that *Zeig* involved a property insurance loss that became fixed when it occurred. *Ali*, on the other hand, involved liability insurance coverage (Directors & Officers policy), which involved the insureds “obligations to pay third parties.” The *Ali* court agreed with the lower court that this obligation to pay could incentivize the insured and its underlying insurers to structure settlements manipulatively to move payment away from the underlying insurers and to the overlaying insurers.⁴⁷

As a speculative proposition, it is, of course, possible that an insured could collude with one of its insurers to the prejudice of another of its insurers. Instances of this occurring have been reported,⁴⁸ and, if it occurs it seemingly would more likely occur between an insured and an insurer the insured had a working relationship with, e.g., the primary layer insurer, and to the prejudice of an insurer the insured had only a distant relationship with, e.g., an excess insurer somewhere in the tower of coverage provided by the

⁴⁷ *Ali*, 719 F.3d at 93-94.

⁴⁸ See e.g., *Kaiser Found. Hosps. v. North Star Reinsurance Corp.*, 153 Cal. Rptr. 678, 682 (Dist. Ct. App. 1979) (involving collusion between insured and primary insurer to allocate dates of loss to transfer loss exposure away from primary insurer and onto excess insurer).

insurance coverage program. That said, it is difficult to conceive of factual scenarios involving collusion that do not involve allowing an underlying insurer to escape its defense obligation. If only indemnity is involved, allowing the underlying insurer to buy its way out of coverage does not financially impact an overlaying insurer because to preserve the overlaying insurance the insured with have to assume the discharged insurer's indemnity obligation in some manner, e.g., by payment (or credit) up to the underlying limits. Thus, a less than limits payment by an underlying insurer has no financial consequences to an overlaying insurer insofar as indemnity is concerned because the overlaying insurer will receive a credit against the loss equal to any difference between the policy limits and the insured-insurer coverage settlement. For example, using Schematic 1, assume Insurer Alpha, with indemnity limits of \$1 million, settles a coverage dispute with the insured for a payment of \$500,000. The claimant and the insured settle a dispute (which only affects the year 1 policies) for \$2 million. Assume further, the Epsilon policy has \$3 million policy limits. Epsilon would pay \$1 million. This reflects the full value of underlying insurance (\$1 million) being credited against the settlement.

This suggests that concern over collusion and manipulation of settlements is misguided. Aside from avoidance of defense costs, insureds and underlying insurers have little or no reason to collude because they are not actually exporting any of their costs to overlaying insurers. Protecting an overlaying insurers' reliance on underlying insurers absorbing defense costs until their policy limits are exhausted by payment of judgments or settlements is not a standalone justification for not treating a within limits settlement between an insured and insurer as exhausting the limits. As noted earlier, the defense will be provided by other primary insurers or the insured so that the overlaying insurer is not prejudiced. A focus on collusion or manipulation adds nothing to the analysis whether the overlaying insurance should be deemed to be "triggered" with respect to excess coverage obligations.

III. EXHAUSTION OF COVERAGE THROUGH NON-CUMMULATION/PRIOR INSURANCE PROVISIONS

Non-Cumulation/Prior Insurance provisions refer to insurance policy terms that provide that the applicable policy limits may be offset by insurance under another policy available to the insured. Non-Cumulation/Prior Insurance provisions are similar to "Other Insurance" provisions in that both seek to reduce the insurer's obligations when the insured is also an insured under other insurance policies that cover the same

insured event. Many courts, however, limit the application of “Other Insurance” provisions to insurers on the same risk in the same policy period and refuse to apply the provision in cases of successive coverage.⁴⁹ Non-Cumulation/Prior Insurance provisions are said to address (from the insurer’s vantage point) the problem raised by the “continuous trigger” “all sums stacking” approach.⁵⁰ Non-Cumulation/Prior Insurance provisions allow the insurer to use payments owed or made under prior policies that apply to the same risk under a continuous trigger to reduce obligations owed under other policies made applicable to the risk by the same continuous trigger. For example, looking at Schematic 3, on page 286, assume under “continuous trigger” “all sums stacking” Insurer Beta’s year 1, year 2, and year 4 policies have all been triggered. A Non-Cumulation/Prior Insurance provision is intended by the insurer (here Beta) to allow it to offset payments made by it from policies at the same layer of coverage. For example, a payment of \$1 million on the year 1, 1st layer excess Beta policy would be credited against the year 4, 1st layer Beta policy. Thus, instead of Beta paying \$1 million on each policy, or \$2 million total, Beta would pay only \$1 million on both policies. The result would be to negate “all sums stacking.” Courts have enforced Non-Cumulation/Prior Insurance provisions when the payments are made by the same insurer⁵¹ and when made by different insurers.⁵² On the other hand, a number of courts have refused to enforce Non-

⁴⁹ See *Ohio Cas. Ins. Co. v. Unigard Ins. Co.*, 564 F.3d 1192, 1196-97 (10th Cir. 2009) (collecting conflicting authorities). The court certified the question to the Utah Supreme Court which held that “Other Insurance” provisions did not apply to successive insurers on the same risk. *Ohio Cas. Ins. Co. v. Unigard Ins. Co.*, 268 P.3d 180, 183 (Utah 2012); see also *In re Viking Pump*, 52 N.E.3d 1144, 1157 (N.Y. 2016) (same).

⁵⁰ See *Viking Pump*, 52 N.E.3d at 1152. The court noted that Non-Cumulation/Prior Insurance provisions are not applicable when a jurisdiction adopts the “pro-rata” rather than the “all sums with stacking” method of allocation because under “pro rata” allocation the insurer is only liable under each triggered policy for that portion of the total loss that occurred in the particular policy’s period of coverage. *Id.* at 1153.

⁵¹ *Olin Corp. v. Am. Home Assurance Co.*, 704 F.3d 89, 102-104 (2d Cir. 2012) (applying New York law) (*Olin III*).

⁵² *Olin Corp. v. OneBeacon Am. Ins. Co.*, 864 F.3d 130, 151 (2d Cir. 2017) (applying New York law) (*Olin IV*).

Cumulation/Prior Insurance provisions, usually on the ground that the provision is ambiguous.⁵³

Schematic 3

\$4 million	Tau	Sigma	Tau	Omega
\$3 million	Chi	Gamma		Chi
\$2 million	Beta		Alpha	Beta
\$1 million	Alpha	Beta		Alpha
	Year 1 Policies	Year 2 Policies	Year 3 Policies	Year 4 Policies

Although Non-Cumulation/Prior Insurance provisions, when enforced, may have their greatest impact on the selection of a continuous trigger allocation method,⁵⁴ the provisions also may influence the exhaustion method adopted by the court. The adoption of the “all sums stacking” approach, because of the presence of a Non-Cumulation /Prior Insurance provision, encourages the adoption of vertical exhaustion over horizontal exhaustion.⁵⁵ If the excess insurance policy expressly provides that its limits are reduced by other payments, those other payments determine whether the excess insurance is available. Requiring exhaustion of all underlying insurance simply adds an additional requirement that is inconsistent with the explicit requirements of the Non-Cumulation /Prior Insurance provision because exhaustion here simply duplicates what is accomplished by an

⁵³ A.B.S. Clothing Collection, Inc. v. Home Ins. Co., 41 Cal. Rptr. 2d 166, 170-173 (Cal. Ct. App. 1995).

⁵⁴ As noted previously, many courts find that the presence of a non-cumulation/ prior-insurance provision in a policy is inconsistent with an insurer’s claim that “pro rata” allocation should be adopted. As noted in *In re Viking Pump*:

[P]olicies containing non-cumulation clauses or non-cumulation and prior insurance provisions...all sums is the appropriate allocation method....[I]t would be inconsistent with the language of the non-cumulation causes to use pro rata allocation here.

52 N.E.3d 1144, 1153 (N.Y. 2016).

⁵⁵ *Id.* at 1156 (stating that “vertical exhaustion is conceptually consistent with an all sums allocation”).

enforceable Non Cumulation/Prior Insurance provision. If, on the other hand, horizontal exhaustion is applied, a question may arise whether a policy that is not fully paid, because of credits applied from other policy payouts, has been exhausted. Overlaying insurers will likely argue that a credit does not constitute “actual payment” of policy limits by payment of judgments or settlements. The presence of Non- Cumulation /Prior Insurance provisions, thus, will likely complicate accessing the insured’s total coverage program. And, if the credit is not treated as an “actual payment,” application of a Non-Cumulation /Prior Insurance provision may possibly foreclose recovery from the overlaying policies due to non-exhaustion of the underlying policy.

IV. INSOLVENCY OF UNDERLYING INSURERS

Insolvency has been addressed most commonly in “continuous trigger” coverage contexts in the area of allocation.⁵⁶ It also arises in the more traditional context of the overlaying insurer’s “drop down” obligations, which typically involves a single policy period containing a single tower of coverage, i.e., concurrent coverage.⁵⁷ There has been relatively little judicial

⁵⁶ See John T. Waldron & Sara N. Brown, *New Jersey Allocation Law: How to Calculate Solvent and Insolvent Insurers Pro-Rata Shares for Long-Tail Claims*, 50 TORT TRIAL & INS. L. J. 747 (2015).

⁵⁷ See, e.g., *Mission Nat’l Ins. Co. v. Duke Transp. Co.*, 792 F.2d 550 (5th Cir. 1986) (holding that insolvency of underlying insurer did not trigger obligation on the part of overlaying insurer to assume the insured’s defense). This issue has generated substantial judicial disagreement in older decisions when there was more variation in coverage language. *Cf. Reserve Ins. Co. v. Pisciotta*, 640 P.2d 764 (Cal. 1982) (holding that policy language triggering overlaying insurers duty to assume the insured’s defense, when “amount recoverable” under the underlying policy was paid, was ambiguous and could be reasonably understood to trigger overlaying insurer’s obligation when insolvent underlying insurer paid all that it could, even though that amount was less than policy limits); *with Moorpark Indus. Inc. v. W. Emps. Ins. Co.*, 429 N.W.2d 213, 218 (Mich. Ct. App. 1988) (stating that term “amount reasonable” is not ambiguous); see generally Jane M. Draper, Annotation, *Primary Insurer’s Insolvency as Affecting Excess Insurer’s Liability*, 85 A.L.R.4th 729, 757-63 (1991) (collecting conflicting decisions whether term “amount recoverable” is ambiguous). See *id.* at 763-75. Modern policies do not use the phrase “amount recoverable” to trigger

discussion of the effect of insolvency on the obligations of overlaying insurers when a “continuous trigger” is applied with the result that coverage is successive rather than just concurrent. That is somewhat surprising given the fact that insurer insolvency will likely be encountered in the “continuous trigger” context given the financial demands continuous trigger theories place on insurers, particularly when “all sums stacking” is imposed.⁵⁸

Traditionally, an indemnity obligation required the payment of the debt for the indemnity to be triggered. Thus, if B was indebted to A and C agreed to indemnify B, A’s ability to compel C to perform required that B sustain a loss. If B was insolvent, C could escape because B sustained no loss, being insolvent. Such a rule would be beneficial to insurers, who traditionally occupy the role of C, while their insureds occupy the role of B; however, most states and standard form policy language have taken this defense away.⁵⁹ Those statutes and policy language apply, however, only when the Bs (insureds) of the world become insolvent. What happens when the Cs of the world (insurers) become insolvent?

Standard form primary policy language does not directly address insurer insolvency; therefore, the issue is usually addressed by examining the policy language that activates the overlaying coverage. In this sense the issue of insurer insolvency is similar to the issues raised by settlements between the insured and an insurer for less than policy limits discussed in Part II of this paper. Does the settlement (here, insurer insolvency) satisfy a requirement in the overlaying policy that conditions coverage on (1) the

coverage; rather, they use the phrased “reduced or exhausted by payment,” or a variant of the phrase, which is generally interpreted to require exhaustion by payment of the policy’s actual, stated limits. *See id.* at 746-57. The term “collectible,” which some courts have found to be “ambiguous” is still, however, used in many excess policies.

⁵⁸ I could not find any data supporting or disproving this assumption. There is no disagreement, however, that adoption of continuous triggers has significantly increased insurer financial obligations to insureds. If it didn’t insureds would not press for it and insurers would not fight tooth and nail against it! Adam Raphael’s book *Ultimate Risk* does attribute Lloyds financial crisis in the 1990’s in significant part to mass tort claims that, through the continuous trigger theory, allowed insureds to aggregate coverage for particular losses across multiple policy periods.

⁵⁹ *See* David Gray Carson, *Indemnity, Liability, Insolvency*, 25 CARDOZO L. REV. 1951 (2004) (discussing distinction between indemnity and liability obligations when the obligor becomes insolvent).

exhaustion of limits by payment of judgments or settlements or (2) for “ultimate net loss” in excess of underlying scheduled or other insurance?

Courts have split as to whether insurer insolvency will result in the inability to satisfy an “ultimate net loss” provision. Much turns on the specific language of the provision and the willingness of a court to deem the provision clear or ambiguous. For example, in *Reserve Insurance Company v. Piscotta*, the California Supreme Court held that “ultimate net loss” language that was tied to the “amount recoverable” was not expressly tied to policy limits; therefore, the insolvency of an underlying insurer required that the overlaying insurer “drop down” and provide coverage.⁶⁰ Not all courts, however, agree with this construction of the phrase “amount recoverable” as ambiguous.⁶¹

In most instances, insurers use language in the “ultimate net loss” clause that courts deem reasonably informs the insured that only full payment of the underlying limits will allow the insured to access the overlaying insurance; consequently, the insolvency of an underlying insurer is often a risk that is borne by the insured, not the overlaying insurer(s). For example, in *Mission National Insurance Company v. Duke Transportation Company*, the overlaying insurer (Mission) conditioned its coverage “to the ultimate net loss the excess of...the limits of the underlying insurance as set out in the attached schedule...”⁶² As a result of the insolvency of the underlying insurer (Northwest), that attachment threshold could not be met. The insured (Duke) argued that this event (insolvency) meant that Mission’s obligations became immediate. In other words, because Northwest could no longer perform its obligations, Northwest’s obligations should be deemed to have been performed. The court rejected this argument holding that Northwest’s insolvency did not excuse the policy requirement that losses as specified be paid before Mission’s obligations would be activated.⁶³

Thus, initially at least, “insolvent insurers cases” tract “settlement within coverage limits” cases. In both cases, the critical issue is whether the

⁶⁰ *Pisciotta*, 640 P.2d 764, discussed in note 57. In effect, one reasonable interpretation of the “amount recoverable” language was that it referred to the amount actually recoverable (or recovered) from the insolvent insurer, not the amount set by the insolvent insurer’s policy limits.

⁶¹ See cases cited *supra* note 57. Nonetheless, the phrase “amount recovery” is no longer used in excess insurance policies.

⁶² *Mission Nat’l Ins. Co.*, 792 F.2d 550, discussed in note 57.

⁶³ *Id.* at 553.

requirement that the underlying limits have been paid in full. In both cases, many courts give primacy to policy language to determine whether full, actual payment of policy limits by the underlying insurer is required as a condition precedent to reach the overlaying insurance. In both cases, modern policy language is often read by courts today as requiring payment of the full limits by the insurer before overlaying insurance may be accessed.

In one way, however, insurer insolvency cases differ from “within limits settlement” between insureds and insurers—the insolvent insurer is liquidated in an administrative proceeding and confirmed by judicial process and review. Unlike the private bargain between the insured and the underlying insurer, insolvent insurer proceedings are specifically designed to provide a fair and efficient resolution of claims given the resources available. The presence of judicial oversight and review may persuade a court that sufficient protections exist so that the interests of overlaying insurers are protected, such that once the claim(s) is/are resolved the court may deem the attachment point satisfied. Judicial approval of a plan of liquidation of the insolvent insurer may be treated as a judicial determination that the attachment point was reached, even though the actual amount provided is less than the policy limits.⁶⁴

V. LOSS ALLOCATION AGREEMENTS BETWEEN INSURED

Insureds often enter into loss allocation agreements with each other and the meshing of these agreements with the risk transfer provided by insurance has proved difficult.⁶⁵ For example, an insured (Contractor) may

⁶⁴ See *Canon Elec., Inc. v. Ace Prop. & Cas. Co.*, Case No. BC 290354 (Superior Court, County of Los Angeles, August 17, 2017) (copy on file with the author). In this matter the trial court concluded that a judicial determination in liquidation of the amount the insolvent insurer would pay satisfies the exhaustion requirement even though the amount paid is less than policy limits. *Id.* at 50-55 (applying New Hampshire law). In effect the court concluded that a court order that the insolvent insurer had paid its obligations under the policy was equivalent to the actual payment of policy limits.

⁶⁵ See 4 PHILIP L. BRUNER & PATRICK J. O’CONNOR, JR., *BRUNER & O’CONNOR CONSTRUCTION LAW* § 11:554 (2d ed. 2017) (noting common use of risk-transfer agreements in construction industry and uncertainty, in the absence of specific identification of the problem in the insurance policy, regarding the primary of the risk-transfer agreement on the policy); Jeremiah M Welch & Julian D. Ehrlich, *Horizontal Exhaustion: Challenges and*

enter into an agreement with a third person (Subcontractor) in which Subcontractor agrees to exculpate the Contractor for all losses arising from Subcontractor’s performance of the agreement.⁶⁶ Contemporaneously, the parties will agree that some or all of the parties will become additional insureds on a party’s existing coverage, to which that party’s insurer(s) agree. To what extent, if at all, should the indemnity agreement affect insurance coverage available to the parties to the indemnity agreement, here, Contractor and Subcontractor? And to the point of this paper, to what extent, if all, should the indemnity agreement affect exhaustion requirements regarding overlaying levels of insurance coverage provided by excess insurers?

An example may help illustrate the problem. Subcontractor agrees to perform work on a construction project being built by Contractor. As part of the agreement, Subcontractor agrees to name Contractor as an additional insured on its (Subcontractor’s) primary liability insurance policy. Contractor has primary liability coverage with Alpha Insurance Company and excess coverage with Beta Insurance Company. Subcontractor has primary liability coverage with Omega Insurance Company and excess coverage with Theta Insurance Company. Both excess coverages purport to

Solutions, 40 NYSBA TORTS, INS. & COMPENSATION L. SEC. J., Summer 2011 at 20.

⁶⁶ This is frequently accomplished by a “waiver of subrogation” rights which bar direct liability to the extent there is insurance in place that covers the loss. The effect of such a provision is to prevent the insurer that pays the loss from claiming reimbursement. These waivers are generally enforced and may not be used by insurers to refute coverage. See BRUNER & O’CONNOR, JR., *supra* note 65; see also 1 SCOTT C. TURNER, INSURANCE COVERAGE OF CONSTRUCTION DISPUTES, §5:7 (2d ed. 1999). A pre-loss release of liability has been treated the same as a waiver of subrogation rights. See *Great N. Oil Co. v. St. Paul Fire & Marine Ins. Co.*, 189 N.W.2d 404 (Minn. 1971). However, this decision involved a first party property insurance policy. In the field of construction disputes many jurisdictions restrict efforts to shift liability beyond that accomplished by insurance by barring insurers from obtaining reimbursement against those deemed additional insureds. See BRUNER & O’CONNOR, JR., *supra* note 65; see also Jay M. Zitter, Annotation, *Insurance: Subrogation of Insurer Compensating Owner or Contractor for Loss under “Builder’s Risk” Policy Against Alleged Negligent Contractor or Subcontractor*, 22 A.L.R.4th 701 (1983).

be excess to the scheduled underlying primary policies and “all other collectible underlying policies.” Finally, Subcontractor has entered into a separate agreement with Contractor in which Subcontractor agrees to indemnify Contractors for any losses resulting from Subcontractor’s performance of its work on the job site pursuant to its contract with Contractor.

Worker is injured on the job site and sues both Subcontractor and Contractor. The claim exceeds the limits of both primary policies, but not the limits of either excess policy. Both Subcontractor and Contractor tender Worker’s claim to all the insurers. Does the presence of the indemnity agreement affect the obligation of Beta Insurance Company (Contractor’s excess) or Theta Insurance Company (Subcontractor’s excess)? Does the indemnity agreement between the insureds affect the determination whether the underlying insurance is “collectible”?

Both excess insurers could argue that under principles of horizontal exhaustion both the Alpha policy (Contractor’s primary) and the Omega Policy (Subcontractor’s primary) must exhaust before either excess insurer must step forward. Does the indemnity agreement between Contractor and Subcontractor change that by shifting responsibility for the loss away from Contractor (and Alpha)?

More importantly, can Theta (Subcontractor’s excess) now disclaim liability on the ground that the Alpha policy has not been exhausted and, therefore, under principles of horizontal exhaustion, it’s (Theta’s) policy has not been triggered? In other words, Theta would contend that the Alpha policy remains “collectible” insofar as the Theta policy is concerned, even though by operation of the insured’s indemnity agreement the loss will be borne by Subcontractor (Theta’s insured)⁶⁷

Most decisions addressing whether insured–insured loss allocation agreements, such as the indemnity agreement between Contractor and Subcontractor, affect insurer obligations have involved disputes between primary insurers. In this context, courts have divided whether one insurer may use a loss allocation agreement, to which it (the insurer) is not a party,

⁶⁷ I am assuming here that Contractor’s Non-liability is the expected outcome. Unlike the insurer’s defense obligation which can be triggered by potential liability within coverage, the insurer’s indemnity obligation rests on actual liability within coverage. However, as a practical matter, the insurer cannot know whether the insured will be deemed liable on nonliable. In the course of defending the insured, the insurer may be forced to make difficult decisions regarding settlement when its coverage obligations are uncertain because the liability of its insured is uncertain.

to escape its obligations under its insurance policy. One line of decisions holds that the insurer may rely on the insured’s explicit loss allocation decisions; another line of decisions holds the insurer to its commitments in its insurance policy and refuses to allow the insurer to use agreements to which it is not a party to escape obligations it has contractually assumed.⁶⁸ For the most part, however, these decisions do not address the issue of exhaustion because they do not involve excess insurance.

Several decisions, however, have specifically involved disputes between primary and excess insurers where one of the insurers is using a loss allocation agreement, to which the insurer it is not a party, to trigger or avoid liability.

In *Bovis Lend Lease LMB, Inc. v. Great American Insurance Company*,⁶⁹ the Contractor and Subcontractor had separate policies and the Subcontractor agreed to add the Contractor as an additional insured to its (Subcontractor’s) policies “without contribution by the Contractor’s own insurance.” A claim was made that would trigger the attachment point of the Subcontractor’s excess insurance, so a dispute arose as to the priority of involved policies. The *Bovis* court held that in the absence of policy language adopting or permitting the adopting of exculpatory agreements between insureds allocating responsibility for a loss, priority of coverage would be determined by policy language and judicially developed coverage rules, here horizontal exhaustion. The court concluded that excess policies would not be triggered until all the underlying primary policies had been exhausted.⁷⁰

In another New York case, however, the court appeared to recognize a loss allocation agreement as excusing the requirement that an underlying policy be horizontally exhausted before the attachment point of an overlaying excess policy would be triggered. In *Indemnity Insurance Company of N.A. v. St. Paul Mercury Insurance Company*,⁷¹ insurers of the

⁶⁸ See generally SCOTT M. SEAMAN & JASON R. SCHULZE, ALLOCATION OF LOSSES IN COMPLEX COVERAGE CLAIMS § 5.4[f] (2018); BRUNNER & O’CONNOR, JR., *supra* note 65.

⁶⁹ See *Bovis Lend Lease LMB, Inc. v. Great American Insurance Company*, 855 N.Y.S. 2d 459, 462 (App. Div. 2008).

⁷⁰ *Bovis Lend Lease v. Great Am. Ins. Co.*, 855 N.Y.S.2d at 464, 470-71.

⁷¹ *Indem. Ins. Co. v. St. Paul Mercury Ins. Co.* 900 N.Y.S.2d 24 (N.Y. App. Div. 2010). Both decisions were from the 1st Department, but the

indemnitor (Subcontractor) accepted tenders of the indemnitee's (Contractor's) defense from the indemnitee's insurer (St. Paul). The indemnitor's insurers, (Royal (primary) and Indemnity Insurance Company of N.A. (excess)), subsequently settled the claim, with Royal paying its limits (\$1 million) and Indemnity Insurance Company paying \$2 million. Indemnity Insurance Company, in turn, sought reimbursement from the indemnitee's insurer, St. Paul. The court rejected Indemnity's claim that St. Paul's obligations were antecedent to its own and required exhaustion. Under the loss allocation agreement, the obligations of the indemnitee (Contractor) and its insurer (St. Paul) would "pass through" to the indemnitor (Subcontractor) and its insurer (Indemnity).

This conflict in approaches is further complicated by the fact that the decided cases involve concurrent coverages rather than successive coverages applicable to a loss under a "continuous trigger" approach. Again, this illustrates the consequences of adopting a horizontal exhaustion requirement that assumes an even, rising tide progressively exhausting layers of coverage. In reality that rising tide must confront numerous obstacles that may interfere with the smooth upwards movement that the rising tide metaphor assumes.

Courts generally have not addressed the issue of the effect of a risk-transfer agreement between insureds on the coverage obligations of insurers in terms of exhaustion. But the effect of choosing to give, or not give, primacy to the risk-transfer agreement may affect how coverage is sequenced. If, on the one hand, the court gives primacy to the insureds' risk-transfer agreement, coverage is limited to the party that has assumed the risks. If vertical exhaustion is used, the obligation of overlaying insurers is determined by looking at coverage within the specific underlying policy period that is activated. However, if horizontal exhaustion is applied, giving primacy to the loss-allocation agreement may result in a loss of coverage because one or more insurance coverages in the insured's insurance program will not be exhausted. If, on the other hand, the court does not give primacy to the insured's risk-transfer agreement, the choice between horizontal and vertical exhaustion will be determined by the coverage language in each insurance policy. As noted in Part I of this paper, the literal terms of most insurance policies can be read, and have been read by courts, as providing for horizontal exhaustion as the pathway to accessing overlaying coverage. In this case, courts must determine whether horizontal exhaustion is the proper method for accessing overlaying coverages when a "continuous

Indemnity Insurance Company court did not cite nor discuss *Bovis Lend Lease*.

trigger” “all sum stacking” approach (“the giant uber-policy”) is adopted. This point is addressed next.

VI. SUCCESSIVE COVERAGE AND EXHAUSTION

As noted in this paper, the issue of exhaustion has normally been considered in the context of concurrent coverage, that is layers of coverage within a single policy year. A few courts have considered the exhaustion issue in the context of successive coverage (caused by application of a “continuous trigger”), but the courts, for the most part, have not viewed concurrent coverage cases different from successive coverage disputes insofar as the exhaustion requirement is concerned. That, in this author’s opinion, is a mistake.

Proponents of horizontal exhaustion often use the metaphor of a rising tide, successively exhausting coverage layer by layer. When exhaustion doctrine is looked at broadly, one sees many situations where underlying policies will not be fully exhausted, due to coverage issues specific to those policies. While the rising tide metaphor makes some sense when applied to layers of coverage within a single policy period, the metaphor is ill-suited to the situation presented in “continuous trigger” “all sum stacking” cases where multiple policy periods are involved and the insured’s coverage profile often differs substantially from year-to-year.

As a practical matter, when multiple policy periods are in play due to the application of a continuous trigger, it is highly likely that one or more of the underlying policies will not pay out its full limits due to one or more of the reasons set out in this paper. If horizontal exhaustion is applied, that failure to pay the full limits will, in effect, block the rising tide of exhaustion. Rather than a rising tide, a more appropriate way of seeing horizontal exhaustion is to envision a rising level of water that must proceed through a plethora of bottlenecks where upward movement will be blocked forever once the bottleneck of a single “unpaid in full” policy is encountered. That consequence is simply inconsistent with the “Uber” policy approach the California Supreme Court adopted in the State of California Continental Insurance Company decision. Horizontal exhaustion effectively transforms the “Uber” policy to a “Mini” policy by providing overlaying insurers with an escape card at the point any single underlying policy fails to pay its full limits. In effect, the “Uber” policy is an illusion if horizontal exhaustion is applied. More perniciously, horizontal exhaustion punishes the insured who acquires more insurance because more insurance increases the risk that one

of the additional insurance policies may fail to pay its policy limits, thus toppling what remains of the insured's coverage program. Or to paraphrase the Notorious B. I. G.: the more insurance a policy holder obtains, adoption of horizontal exhaustion means the more problems the insured has in collecting on any of the policies.⁷²

When successive coverage arises by operation of a "continuous trigger" "all sums stacking" approach, the question is squarely presented how the overlaying coverage should be accessed. Simply adopting a solution by arguing that horizontal exhaustion is more consistent with the nature of the relationship between primary and excess insurance is insufficient for several reasons. First, successive coverage simply presents a different context in which coverage questions must be resolved and ignores the fact that the "continuous trigger" doctrine was adopted to address problems caused by great societal problems (asbestos, environmental degradation, etc.) which could be addressed more efficiently and effectively through the cost sharing and cost spreading attributes of insurance. Second, horizontal and vertical exhaustion requirements are complicated doctrines. As shown in this paper, whether and when, if ever, an underlying policy is exhausted and whether and when, if ever, an overlaying policy must respond to a loss is often a question fraught with uncertainty in the concurrent coverage context; that question becomes exponentially more uncertain when coverage is expanded in the successive coverage context. Third, treatment of an exhaustion requirement in successive coverage cases should reflect the reasons and values that led to the recognition of successive coverage through adoption of the "continuous trigger" "all sum stacking" approach.

The approach that is plainly inconsistent with successive coverage is horizontal exhaustion. Adopting horizontal exhaustion, when coupled to the doctrine discussed in the paper, will often result in overlaying insurers completely escaping liability because one or more underlying policy in one or more years of the continuous trigger was not exhausted. The practical effect of adopting horizontal exhaustion is to limit successive coverage to primary insurers and give all overlaying insurers arguments to escape coverage all together. That would render the "continuous trigger" "all sums stacking" approach a toothless doctrine.

⁷² NOTORIOUS B.I.G., MO MONEY, MO PROBLEMS (Bad Boy Records and Arista Records 1997).