

# Horizontal Exhaustion: Challenges and Solutions

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In today's tough economic climate, unmet insurance expectations can result in a holdback of contract payments, turn an otherwise profitable job unprofitable or bust a deal and even a company.

Often the greatest difficulty in resolving high value cases is not disagreement with the claimant over settlement values but rather disagreement between the defendants and their carriers over who owes payment of the claim and the order of insurance policy obligations.

Owners, tenants, general contractors and trades typically agree to allocate or transfer risk through the use of two types of provisions in their contracts, namely indemnity and insurance procurement. These provisions are intended to determine who pays and in what order before any claim occurs. To a large extent, when used in conjunction, indemnity and insurance procurement provisions complement each other and are different paths to push responsibility downstream with the same outcome.

However, the determination of party and carrier obligations depends upon the interpretation of both agreed-to contract wording and the language of applicable insurance policies by courts of the relevant jurisdiction. Moreover, courts have recognized that carriers are not parties to, or necessarily bound by, the construction contracts.

One manifestation of this recognition which has been particularly vexing and frustrating to parties is the "horizontal exhaustion" rule. This rule has resulted in several recent court decisions that dictate outcomes that are contrary to the parties' intentions. This leaves party expectations unmet and, worse yet, at times even leaves claims uncovered by insurance.

This discussion will review the horizontal exhaustion rule, how it relates to contractual indemnification and then examine how parties to construction contracts can best increase the likelihood that losses will be paid in accordance with their expectations and covered by insurance. Although these issues present frequently in the construction site accident context, the same issues arise in claims against landlords and tenant as well as other scenarios involving multiple defendants who have entered into agreements contemplating risk transfer.

## 1. Horizontal v. Vertical Exhaustion

"Horizontal exhaustion" is the principle of insurance priority whereby an excess policy is not triggered unless *all* applicable primary policies have exhausted. Although the principle is simply stated, its application can become complex when multiple parties, contracts and layers of insurance are involved.

"Vertical exhaustion," by contrast, is the priority principle that primary and excess policies purchased by the downstream entity pay before any policies purchased by the upstream entity. Typically, vertical exhaustion reflects the intent of the parties seeking to transfer risk downstream.

Nonetheless, horizontal exhaustion has become the default rule in a number of influential states including New York, California and Illinois.<sup>1</sup>

Understanding horizontal exhaustion from the eyes of the insurer, the insured and the court is the path to potential solutions for parties. A study of horizontal exhaustion's evolution through the New York courts provides a useful perspective. But first, a brief review of risk transfer concepts is necessary to lay a foundation for further analysis.

## 2. Insurance Procurement and Contractual Indemnity Obligations

Insurance procurement and contractual indemnity each have their strengths and weaknesses. Accordingly, most contracts obligate the downstream party to provide both.

Additional insured coverage has the benefit of giving a buyer or receiver of services direct access to the seller's or service provider's insurance, which can actually avoid the need for litigation between the contracting parties. Moreover, broad additional insured endorsements will provide upstream entities with coverage for their own active negligence.<sup>2</sup>

However, this track of risk transfer is restricted to the limits of insurance purchased by the downstream party. The upstream party must also comply with the terms and conditions of those policies. This can present practical problems of knowing what those terms are since it is commonplace for policyholders to have difficulty timely obtaining copies of their policies and, correspondingly, even more challenging for additional insureds to get copies of policies they did not purchase.<sup>3</sup>

Thus, a typical contract between an owner or general contractor and a trade subcontractor also includes an indemnity agreement requiring the trade contractor to defend and indemnify the owner and/or general contractor from any liability arising out of the trade's work. Contractual indemnity has the advantage of not being restricted to policy limits. This track also does not subject the upstream party to the myriad of exclusions and conditions that may be on the policy purchased by the contractor.

However, most states limit the scope of permissible indemnity based on public policy. New York, like most, prohibits indemnity for a party's own negligence. Therefore, contracts typically provide for indemnity up to the limits allowed by law. Moreover, while additional insured status requires a viable insurance carrier to recover, contractual indemnity requires a viable downstream contractor with assets or coverage for itself to satisfy the relief.

### 3. Issues Arise

Additional insured coverage is typically required on a "primary and noncontributory basis" precisely because the upstream party wants the additional insured coverage to pay before the upstream party's own insurance, i.e., vertical exhaustion.

However, due to the realities of the insurance marketplace, the limits called for in many contracts typically exceed what a trade contractor can purchase in a primary policy. Accordingly, most additional insured coverage is provided through a combination of primary and excess insurance. The contracting parties intend that where the additional insured coverage involves both primary and excess policies, the excess policy should respond *before* any of the additional insured's own primary insurance.

Disagreement begins when the excess carrier, whose coverage the first named insured has pledged to an additional insured on a primary basis, takes a different view on which policy is triggered next. Typically, excess policies state that their coverage is not triggered until all applicable underlying insurance has exhausted. Accordingly, excess carriers resist vertical exhaustion in the additional insured setting, and instead argue for "horizontal exhaustion"; i.e., that the additional insured's own primary insurance must exhaust before the excess policy is triggered.

Moreover, the excess carriers' priority position is often not contained in any coverage position letter since the carrier is not technically denying or reserving the right to deny coverage. Thus, as a practical matter, excess carriers may not make their horizontal exhaustion position known until settlement negotiations begin in earnest, maybe on the eve of trial. In addition, a horizontal exhaustion priority position may mean, in effect, that the excess carrier refuses to contribute at all to a settlement if the value of the case is within all primary policy limits.

### 4. The *Bovis* Decision

In the landmark 2008 decision of *Bovis Lend Lease LMB, Inc. v. Great American Insurance Company*,<sup>4</sup> New York's First Appellate Department held that priority of insurance coverage is determined only by the insurance policies themselves, and not by trade contracts. Put simply, a contractor's promise to provide certain limits of insurance to an upstream party on a "primary and

non-contributory basis" is not enough to achieve vertical exhaustion.

The *Bovis* decision provides an instructive exemplar.

The New York appellate court's decision in *Bovis* announced to the contracting world that New York had joined the ranks of the horizontal exhaustion states. *Bovis* involved the question of insurance priority between a subcontractor's excess general liability policy and the general contractor's own primary general liability policy.

The Court ruled that horizontal exhaustion applied because it found no evidence in the excess policy itself that the policy was supposed to respond on a primary basis for an additional insured. The Court reasoned that the excess carrier should not be bound by a trade contract that it was not a party to, and which was created after the policy was already in place.<sup>5</sup>

Interesting to note is that *Bovis* was a declaratory judgment action pertaining only to priority of coverage issues. Thus, the Court specifically declined to rule on the contractual indemnity claim as that claim was not before it. Accordingly, this decision did not answer the question of who ultimately pays the claim. The underlying personal injury matter subsequently settled before further motions or appeals answering that question were heard.

The Court's reasoning flowed from traditional contract principles, and while the result may have frustrated the business purposes of the contracting parties, the terms of the excess policy may well have warranted such a finding.

It is important to recognize that where an excess insurer successfully argues horizontal exhaustion to defeat an additional insured's coverage claim, the first named insured will likely still be liable to the additional insured/upstream party for: (1) breach of contract to purchase insurance (i.e., the trade contract called for a certain limit of primary insurance which the downstream party has now failed to provide), and (2) contractual indemnity.

However, most insurance does not cover breach of a contractual insurance procurement promise, and while the first named insured's contractual indemnity liability is typically covered (i.e., "insured contract" coverage), a suit between the contracting parties is usually necessary. Moreover, in the general liability context, defense costs typically do not deplete indemnity limits, whereas defense costs sought as part of a contractual indemnity claim are paid as damages, and therefore do deplete indemnity limits.

### 5. Potential Solutions

The same New York appellate court's recent decision in *Indemnity Insurance Company of North America v. St. Paul Mercury Insurance Company*<sup>6</sup> provides an important excep-

tion to the application of horizontal exhaustion, which has also been recognized by many other courts around the country, known as “circuitry of litigation.”

In many jurisdictions, the courts will not apply horizontal exhaustion where the target primary policy’s insured owes contractual indemnity for the sum in question to the party on whose behalf the excess insurer paid. This is referred to as “circuitry of litigation” because in this situation, applying horizontal exhaustion would just result in litigation by the additional insured against the first named insured, and the excess carrier would then be obligated to indemnify the first named insured. “Circuitry” refers to the concept that whatever indemnity the excess carrier could avoid as respects the additional insured through horizontal exhaustion would come back around to it anyway on the contractual indemnity claim. Rather than force a second round of litigation, the courts elect to shortcut the process and make the excess carrier pay the additional insured on a vertical basis.

*Indemnity* is the first such case for New York.<sup>7</sup> In *Indemnity*, the Court affirmed the horizontal exhaustion rule but stated the rule was “irrelevant” since 1) contractual indemnity against the downstream trade contractor at fault had been established, and 2) the contractors’ excess policy had accepted additional insured status to the owner and general contractor “without reservation or qualification.”<sup>8</sup>

In light of the *Indemnity* decision, additional insureds with contractual indemnity rights against a named insured should consider promptly establishing a contractual indemnity claim via summary judgment motion as a potential tool to defeat horizontal exhaustion.

However, parties should be mindful that 1) tender acceptances by downstream excess carriers may reserve priority of coverage positions and 2) “clean” contractual indemnification pass throughs will not be possible where there are questions as to the upstream entities’ negligence.

Moreover, the Court in *Indemnity* addressed an important concept known as anti-subrogation that may bar contractual indemnity claims. Under the anti-subrogation doctrine, recognized in many states as pre-indemnification, where an insurer provides coverage from the same policy to two insureds, cross claims between those insureds are barred to the limits of the policy.

So, for example, in *Indemnity*, since the trade contractors’ primary and excess GL policies acknowledged additional insured status to the owner and general contractor, those parties’ claims, including contractual indemnification claims, against the trade were barred up to the limits of the excess policy. Interestingly, and for the first time in New York, the Court in *Indemnity* applied the anti-subro-

gation doctrine even where the trade contractors’ excess carrier took a horizontal exhaustion position.

In addition, the *Bovis* decision, and others like it around the country, point the way to another potential solution, which is the specific endorsement of excess policies to provide that they will provide primary and noncontributory coverage for additional insureds where required by contract. This solution has yet to be tested in the excess versus primary horizontal exhaustion context, but the New York courts have certainly embraced the concept of a policy allowing its priority of insurance to be determined by a trade contract.<sup>9</sup>

In the authors’ experience, excess carriers have generally been willing to address horizontal exhaustion from an underwriting point of view and have provided coverage consistent with trade contract promises.

This solution is not perfect. It puts an administrative burden on owners and upstream parties to ensure that their downstream parties have properly endorsed their excess coverage. Again, it is difficult and perhaps impractical to actually review downstream parties’ policies to verify compliance. Upstream parties often rely on contractual promises and certificates of insurance, but neither of these is actually binding on the insurer from whom the coverage ultimately must come.

## Conclusion

As this discussion has intended to highlight, there simply is no way to absolutely ensure that all risks are always transferred smoothly the way the parties intend.

Upstream parties are, to some extent, at the mercy of downstream contractors properly fulfilling their obligations to purchase insurance that will meet the parties’ expectations. Timely tenders based on both additional insured status and contractual indemnity to downstream parties and carriers are important but no guarantee that risk transfer will work as expected. Even prompt summary judgment motions will not prevent priority of coverage positions from impeding claim resolutions.

The insurance industry has yet to make endorsements that reflect the parties’ desire for vertical exhaustion a standard part of general liability excess coverage. Until this happens, risk managers are best served by knowing the likely carrier positions and understanding governing principles such as priority of coverage, circuitry of litigation and anti-subrogation as interpreted in their jurisdiction.

## Endnotes

1. *Bovis Lend Lease LMB v. Great Amer. Ins. Co.*, 855 N.Y.S.2d 459 (App. Div. 1st Dept. 2008); *Kajima Const. Services, Inc. v. St. Paul Fire and Marine Ins. Co.*, 227 Ill. 2d 102 (2007); *Reliance Nat’l v. General Star Indemnity*, 72 Cal. App. 4th 1063 (1999).

2. Policies differ on the scope of additional insured coverage. Most policies require that the additional insured's liability either "arise out of" the work of the first named insured, or result from an "act or omission" of the first named insured.
3. For example, the New York State Insurance Department issued an advisory in Circular Letter No. 20 on October 16, 2008 that required carriers to promptly issue and deliver policies within 30 days of inception.
4. 53 A.D.3d 140 (1st Dept. 2008).
5. The *Bovis* court also noted that the premium paid for the excess policy was much lower than the primary policy, which reinforced its finding that there was no evidence that this particular excess carrier had agreed to be primary under any circumstances.
6. 74 A.D.3d 21 (1st Dept. 2010).
7. In *Tishman v. Great American*, 861 N.Y.S.2d 38 (1st Dept. 2008), a significant New York horizontal exhaustion decision following

*Bovis*, circuitry of litigation was not raised and the published decision is silent as to what contractual indemnity rights existed between the insureds, if any.

8. *Id.* at 28. Note that the *Indemnity* court also based its decision on the fact that the additional insured's primary carrier was never afforded the opportunity to participate in the settlement decision.
9. *Pecker Iron Works of N.Y. v. Traveler's Ins. Co.*, 99 N.Y.2d 391 (2003).

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