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MAKING SURE SOMEONE ELSE'S INSURER PAYS FIRST

Companies often caught off guard by 'horizontal exhaustion'

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If a corporation is *potentially* liable for damages, one of the first goals of risk managers and in-house lawyers is to look for sources of recovery beyond the corporation's own assets. This is also true for insurance claims.

Even if a corporation has insurance coverage, it should always consider whether someone else's insurer should pay first. Having one's own insurer pay a claim is not without consequences to the policyholder. First, the limits of liability for the insurance policy paying out are reduced. Second, the "claims history" is affected, causing the insured to pay higher premiums for insurance in the future. Finally, and most important, having someone else's insurer pay avoids the substantial SIR, or deductible, carried by corporate policyholders.

The primary mechanism by which a corporation may transfer risk to another party is the contractual risk transfer schemes common in most commercial contracts, such as an indemnity agreement. Additionally, one party is usually required to add the other party as an additional insured on their insurance policy. This happens in many industries. In construction, for example, the owner usually requires the retailer to name the owner as an additional insured. In commercial real estate, the owner usually requires additional insured coverage from the tenant. And in manufacturing scenarios, the retailer requires the manufac-



turer to name the retailer as an additional insured. The amount of coverage required is also usually specified.

To satisfy the amount of insurance contractually required, a company will usually purchase both primary and excess insurance. For example, if a retailer requires a manufacturer to obtain \$5 million of additional insured coverage for the retailer, the manufacturer may purchase a \$1 million primary policy and a \$4 million excess policy. Combined with the retailer's own corporate primary and excess coverage, the retailer now has multiple layers of coverage. A common problem, however, is the order of payout of all of these policies when a loss exceeds the limits of the primary additional

insured policy.

To illustrate, in the above example assume that the retailer has its own \$2 million primary policy and a \$10 million excess policy in addition to the additional insured coverage specified, and there is liability of \$5 million for a personal injury judgment against the retailer arising out of the manufacturer's product.

The retailer would expect that all \$5 million dollars of the manufacturer's insurance would pay for the loss. Many excess insurers (and some courts), however, take the position that all of the primary policies must be exhausted before any of the excess policies apply. The principle that all primary policies must be exhausted before any excess coverage applies is known as horizontal exhaustion. Horizontal exhaustion in our hypothetical means that the additional insured primary carrier would pay its \$1 million; then the corporate primary carrier for

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the retailer would pay the next \$2 million; and then the last \$2 million would be paid by the additional insured excess insurer (or a combination of the two excess insurers).

Vertical exhaustion, on the other hand, refers to the exhaustion of a tower or layers of coverage (both primary and excess) before moving horizontally to other applicable primary policies.

Horizontal exhaustion means that the retailer must satisfy its own corporate primary deductible and it would have its claims history impacted resulting in higher future premiums. This very situation happens all the time and commercial parties expecting additional insured coverage are caught off guard because they assumed that all coverage promised would be exhausted *before* their corporate program would be required to respond.



Vertical Exhaustion Strategy

Courts confronting the order of policy payouts issue typically analyze the competing policies' "other insurance" provisions. These provisions usually provide that the insurance is excess of any other valid and collectible *primary* additional insured coverage. Thus, the insurance policy language is the place to start in an effort to achieve vertical exhaustion. First, companies should be sure to ask their own insurers to add endorsements to their policies which specifically state that the insurance is intended to be excess of all additional insured coverage, whether primary or excess.

Second, the intent of the parties can impact the order of policy payouts issue. Accordingly, if it is the intent of the parties that all additional insured coverage, both primary and excess, be exhausted first, then the contract between the parties should clearly state that all coverage will apply on a primary, non-contributory basis. Moreover, the party procuring the additional insured coverage can request from its own insurers, both primary and excess, an endorsement acknowledging the agreed upon vertical exhaustion or, at a minimum, an endorsement which requires the insurers to look to the contract between the parties to determine the priority of coverage.

Finally, choice of law can significantly impact the issue of horizontal versus vertical exhaustion. Accordingly, parties should be aware of the state of the law on this issue in the relevant jurisdiction.

Taking these steps can help achieve vertical exhaustion and result in the application of another party's insurance before your own, thereby avoiding the negative consequences of accessing your own corporate coverage. ■

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