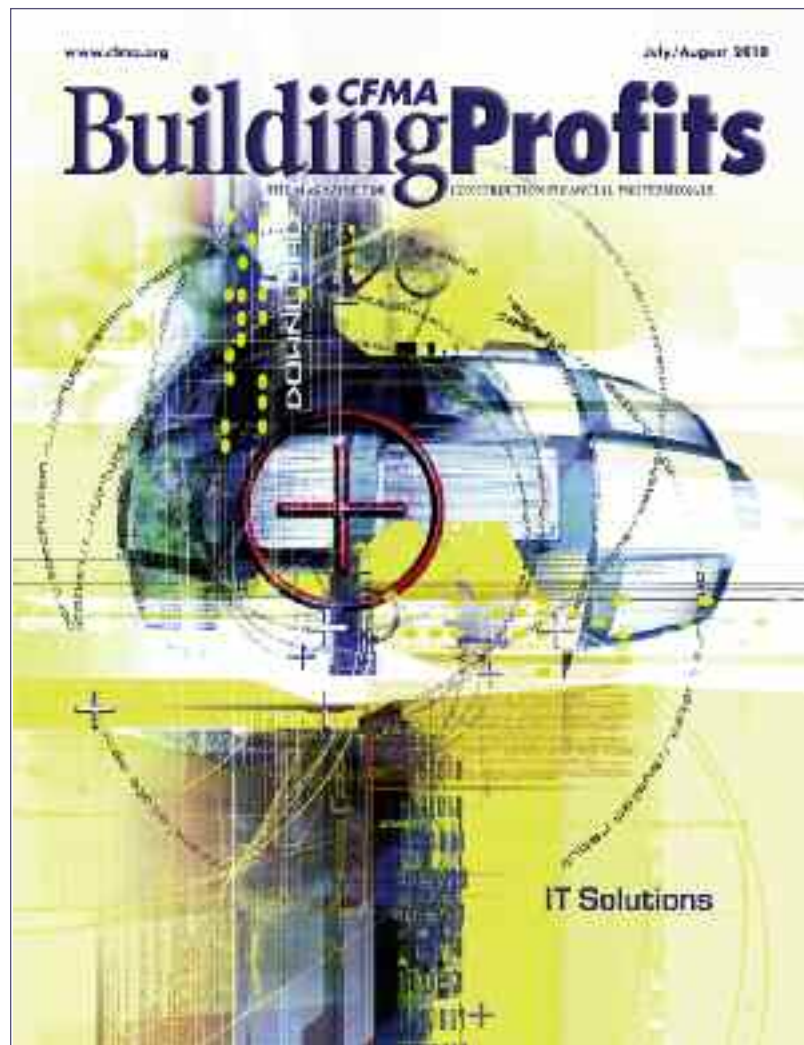


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# Which Insurer Pays? The Horizontal/ Vertical Exhaustion Debate

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On commercial construction projects, subcontractors are often required to obtain liability insurance to cover the GC as an additional insured. The GC will also have its own liability insurance program, thus providing multiple sources of coverage for any given project.

When a loss occurs, a GC will typically look to its additional insured (i.e., subcontractor-purchased) coverage before turning to its own policies. The GC's goal: To preserve available policy limits and to minimize its loss history, which in turn keeps premiums down.

With respect to priority, a subcontractor's primary policy will often, but not always, be required to cover a loss before the GC's primary coverage is required to pay. This is due to language commonly found in modern liability policies, which states that additional insured coverage will pay first.<sup>1</sup> Disputes arise, however, when a loss exceeds the limits of the primary layer of the subcontractor's policy on which the GC is an additional insured.

In this situation, the GC would seek payment from the subcontractor's excess policy(ies) before turning to its own (named-insured) primary coverage – an order of payment known as “vertical exhaustion.” Not surprisingly, excess carriers (and sometimes subcontractors) will oppose this approach, arguing that the GC (as the additional insured) must utilize all available primary insurance before any excess coverage can be tapped – an order of priority known as “horizontal exhaustion.” This article addresses these two competing theories of coverage priority.

## Excess vs. Primary Coverage Layers

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The debate over horizontal vs. vertical exhaustion focuses largely on contract principles. Some courts note that the general function (or contractual purpose) of an excess policy is to provide coverage upon the exhaustion of the insured's primary layer of insurance (i.e., that the intent of an excess policy is to in fact be “excess”).<sup>2</sup>

Other courts look to the contractual agreements between the GC and subcontractor when determining the order of

payment. Construction agreements almost always obligate the subcontractor to indemnify the GC for liability involving bodily injury or property damage at the project.<sup>3</sup>

Courts focusing on the indemnity language contained in the trade agreement opine that the priority of coverage must reflect the duty owed by the subcontractor to the GC. Thus, in essence, the dispute over horizontal vs. vertical exhaustion often involves the question of whether the language and purpose of the excess policy dictates the outcome or if the language of the trade agreement controls.

## Horizontal Exhaustion

As mentioned, courts subscribing to the horizontal exhaustion approach consider it a fundamental principle of insurance law that an excess policy is a payer of last resort. For example, in *JPI Westcoast Constr., L.P. v. RJS & Assocs., Inc.*, 68 Cal. Rptr. 3d 91 (Cal.App. 2007), the California Appellate Court adhered to this philosophy and, accordingly, held that an excess insurer can never be required to pay before the exhaustion of all available primary insurance:

“[H]ere we are faced with a subrogation claim by a secondary or excess carrier, Great American, and a primary carrier, Transcontinental. California insurance law recognizes a fundamental distinction between primary and excess insurance coverage . . . In short, excess insurance is insurance that is expressly understood by both the insurer and insured to be secondary to specific underlying coverage which will not begin until after that underlying coverage is exhausted and which does not broaden that underlying coverage.”<sup>4</sup>

The Court further noted that the dichotomy between primary and excess coverage is reflected in the lower premium charged by the excess insurer. Likewise, in the case of *Kajima Constr. Servs. Inc. v. St. Paul Fire and Marine Ins. Co.*, 879 N.E.2d 305 (Ill. 2007), the Illinois Supreme Court held that all applicable primary policies must be exhausted before a policyholder can selectively tender, or target, excess insurance. According to the Court:



“Given the clear distinctions between primary and excess insurance coverage, we decline to extend the targeted tender doctrine to require one insurer to vertically exhaust its primary and excess coverage limits before all primary insurance available to the insured has been exhausted. Extending the targeted tender rule to require an excess policy to pay before a primary policy would eviscerate the distinction between primary and excess insurance.”<sup>5</sup>

In accordance with the horizontal exhaustion rule, a number of courts have further held that “other insurance” provisions found within primary policies, which assert that coverage is “excess” to other available insurance, do not apply to coverage afforded under a true excess policy. Thus, the “other insurance” clause cannot be considered an instrument by which to place a true excess policy on equal footing with a primary policy.

For example, see *North River Ins. Co. v. American Home Assur. Co.*, 257 Cal. Rptr. 129 (Cal. App. 1989), which stated:

“An ‘other insurance’ dispute can only arise between carriers on the same level, it cannot arise between excess and primary insurers. (125 Cal. App. 3d at p. 598) American Home argues that the American Home claims made ‘other insurance’ provision requires that the North River policy be exhausted, or at the very least prorated with the American Home policy. American Home further contends this ‘other insurance’ provision makes its policy excess to North River’s policy. . . [However] an ‘other insurance’ provision applies only to policies at the same level.”<sup>6</sup>

As noted, the courts adopting the horizontal exhaustion rationale have focused on the specific policy language involved, the perceived fundamental distinction between primary and excess coverage, and the lower premium charged for excess insurance.

### Vertical Exhaustion

In comparison, courts adopting the vertical exhaustion perspective have viewed the indemnity obligation, which is contained in the trade agreement, as the pivotal factor. This is because the indemnity clause reflects the understanding between the contractor and the subcontractor as to who is primarily responsible when a liability claim arises.

It is believed that the trade agreement not only reflects an understanding that the indemnitor (subcontractor) protect the indemnitee (GC) from liability, but further that the insurance acquired by the indemnitor pays first, in keeping with the desired risk transfer arrangement.

One of the most notable decisions subscribing to this logic is *Wal-Mart Stores, Inc., v. RLI Ins. Co.*, 292 F.3d 583 (8th Cir. 2002). The *Wal-Mart* case involved a dispute between the excess insurer of a defective lamp manufacturer, RLI, and Wal-Mart’s primary insurer, National Union Fire Insurance Company. A Wal-Mart customer purchased the defective lamp and was severely injured when the lamp caused a fire.

The customer filed a lawsuit against Wal-Mart and the lamp manufacturer. The case ultimately settled for \$11 million. An agreement existed between Wal-Mart and the manufacturer under which the manufacturer agreed to indemnify Wal-Mart from liability. The manufacturer’s primary insurance carrier, St. Paul, paid its policy limits of \$1 million and the excess carrier, RLI, paid the remaining \$10 million of the settlement. Thereafter, National Union was ordered by the lower court to reimburse RLI the full \$10 million.

On appeal, the 8th Circuit reversed the decision and determined that the indemnity agreement within the Wal-Mart/manufacturer contract controlled the issue of insurance priority, and therefore, held that Wal-Mart’s primary insurance was subordinate to the excess coverage offered under the RLI policy. The Court so stated:

“Because the indemnification agreement creates rights in Wal-Mart and National Union to recover money paid in the settlement, the relationship between the indemnity contract and the insurance-allocation issues makes consideration of the indemnity contract necessary to resolve the dispute. When we analyze the parties’ obligations under both the insurance contracts and the indemnity agreement, we conclude that the indemnity agreement controls the outcome of this case.”<sup>7</sup>

In the decision, the 8th Circuit further dispels the argument that an excess policy is necessarily excess to all primary insurance available, as opposed to a single underlying policy:

“[T]he labels ‘primary’ and ‘excess’ are shorthand for priority of payment obligations. In our case, we agree that RLI explicitly made itself ‘excess’ to St. Paul. The RLI policy specifically referenced the St. Paul policy. We fail to see why RLI deserves the benefit of being ‘excess’ to [Wal-Mart’s insurer] National Union, an insurer it knew nothing about . . . [W]hen an indemnity agreement is put at issue by a party in an insurance-allocation dispute, the effect and purpose of such an indemnity agreement may govern the allocation of liability, despite policy language that would require a different result.”<sup>8</sup>

Finally, the Court also noted that its decision was based, in

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part, on a practical consideration of avoiding the “circuitry of litigation.” This means that if Wal-Mart’s primary carrier, National Union, were held responsible to pay the \$10 million, it would have likely subrogated to Wal-Mart’s interest and thereafter sued the lamp manufacturer pursuant to the contractual indemnity agreement between Wal-Mart and the manufacturer. The manufacturer would then have turned to its insurer, RLI, for defense and indemnity from National Union’s lawsuit. Thus, ultimate responsibility for payment – regardless of whether the horizontal or vertical exhaustion approach applied – rested with RLI.

Similarly, in *Hertz Equip. Rental Corp. v. Ammon Painting Co.*, 2009 Mo. App. LEXIS 1131 (Mo. Ct. App. Aug. 4, 2009), the Missouri Appellate Court adopted the vertical exhaustion logic applied in the *Wal-Mart* case, and further, rejected the holding reached in the *JPI Westcoast* case. The Court acknowledged the argument raised in the *JPI Westcoast* case and the preceding case of *Reliance Nat. Indem. Co. v. General Star Indem. Co.*, 85 Cal. Rptr. 2d 627 (Cal. App. 1999) that an excess carrier’s secondary payment status is reflected by the lower premiums charged; but, the Court further noted that the lower premium does not contemplate coverage purchased directly by an additional insured. Moreover, *Hertz Equip.* held that a horizontal application of coverage priority ignores the indemnity obligation of the subcontractor:

“Like the excess insurer in *Wal-Mart*, Ammon’s excess insurer, Assurance, set its premiums based on the assumption that Ammon already had primary insurance with Valiant. Assurance points to nothing in the record to establish that it set its premiums based on the assumption that two primary carriers would have to exhaust their policy limits before Assurance would be required to provide excess insurance coverage. “Thus, since the trial court required Valiant to exhaust its policy limit before it held Assurance liable for CSC’s remaining loss, Assurance received the benefit of its bargain with Ammon. And, like *Wal-Mart*, CSC signed an indemnification agreement with Ammon in which Ammon promised to indemnify it from liability from any claim arising out of the use of its equipment. To force CSC’s primary insurance carrier, Travelers Indemnity, to assume liability before Ammon’s excess insurance carrier, Assurance, would defeat CSC’s purpose in negotiating the indemnification agreement in the first place. Finally, our holding today avoids the circuitous litigation scenario outlined in *Wal-Mart*.”<sup>9</sup>

More recently, in the case of *Indemnity Ins. Co. of N. Am. v. St. Paul Mercury Ins. Co.*, 900 N.Y.S. 2d 24 (N.Y. App.

2010), a New York Appellate Court determined that the GC’s primary carrier (which insured the City of New York) was not responsible to reimburse payment of a settlement amount paid by an excess carrier of a subcontractor.

The Court’s finding was based in large part on the fact that the subcontractor had acknowledged its indemnity obligation to the GC and the City and, in fact, had accepted unconditionally the tender of defense from the City:

“In determining priority of coverage among different insurers covering the same risk, a court must consider the intended purpose of each policy ‘as evidenced by both its stated coverage and the premium paid for it, as well as . . . the wording of its provision concerning excess insurance.’ Here, however, priority of coverage is irrelevant . . . Even if St. Paul’s coverage of the City were primary to that of IICNA, the City’s liability still would pass through to [the subcontractor] and its insurers, Royal and IICNA. This is particularly so because [the subcontractor] accepted tender of the City’s defense and unconditionally and without reservation agreed to defend and indemnify the City.”<sup>10</sup>

Here again, the indemnity obligation controlled the priority of coverage. This outcome, which emphasized the indemnity agreement over the policy language, prevailed despite existing New York Appellate Court precedent that had adopted horizontal exhaustion in similar settings. *See Tishman Constr. Corp. of N.Y. v. Great Am. Ins. Co.* 861 N.Y.S. 2d 38 (N.Y. App. 2008) (applying the horizontal exhaustion rule).

## Conclusion

As the previous cases illustrate, the courts are divided on the question of whether coverage priority is dictated by the parties’ contractual agreements or by the policy language that reflects the traditional distinctions between primary and excess insurance.

Indeed, the decisions addressing the question of horizontal vs. vertical exhaustion appear to be fairly evenly split. So, policyholders confronting losses that implicate multiple policies are wise to be familiar with all relevant policies (primary and excess) and the contractual indemnity agreements that are in place for any given construction project.

Perhaps more importantly, however, it’s critical to be aware of the potential legal jurisdictions, which could possibly govern a dispute as to coverage priority, should a loss at a construction project arise. ■



## Endnotes:

1. Most liability policies contain language in their "other insurance" provisions, which states that coverage is excess where any other primary insurance is available to the insured for which the insured has been added as an additional insured. However, not all insurance policies specify that additional insured coverage is primary. In such cases, it could be determined that the GC's policy and the subcontractor's policy must contribute toward the loss in a proportionate fashion. *See Briarwoods Farm, Inc. v. Cent. Mut. Ins. Co.*, 866 N.Y.S. 2d 847 (Sup. Ct. 2008).
2. The language of excess policies often signifies that such policies pay last (albeit they do not necessarily state that they are excess to all available primary coverage, as opposed to the particular policy for which it sits above).
3. Most jurisdictions permit contractual indemnity provisions, so long as the provision does not require the subcontractor to indemnify the GC for its own negligence. Some jurisdictions will permit the GC to be indemnified, even for its own negligence, so long as the indemnity provision is clear and specific.
4. *JPI Westcoast* 68 Cal. Rptr. 3d at 99-100 (internal quotations and citations omitted).
5. *Kajima* 879 N.E. 2d at 314. The Illinois Supreme Court addressed the Illinois rule of "target tendering" which permits an insured to select from among its available policies that policy which will pay first. The Court acknowledged the Illinois rule that a specific *primary* policy can be selected as the desired payer of a loss, but nevertheless held that an insured cannot select payment from an *excess* carrier if other primary coverage is still available.
6. *North River* 257 Cal. Rptr. at 132.
7. *Wal-Mart* 292 F. 3d at 589.
8. *Id.* at 592.
9. *Hertz Equip.* 2009 Mo. App. LEXIS 1131 at \*38.
10. *Indemnity Ins. Co.* 900 N.Y.S. 2d at 28 (internal citations omitted).

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