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California Supreme Court allows vertical exhaustion of excess coverage

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JUNE 9, 2020

Over the past several decades, the California Supreme Court has gradually resolved a series of issues that arise in disputes over liability insurance coverage for continuous, progressive injury or damage.

In disputes over coverage for asbestos liability, environmental liability, and construction defects, the court has decided when the primary layer of liability coverage is triggered, how to allocate coverage among triggered primary policies, and whether insureds can "stack" the liability limits of triggered policies.

Left unresolved until recently have been questions regarding how and it what sequence the insured may tap excess layers of coverage.

The California Supreme Court took a major step toward answering those questions.

Vertical exhaustion allows Montrose to obtain coverage under any excess policy once it has exhausted the policies directly underlying the selected excess for the same policy period.

In *Montrose Chemical Corporation v. Superior Court of Los Angeles,* 9 Cal. 5th 215, 2020 WL 1671560 (April 6, 2020), the court ruled that once all primary liability insurance applicable to a continuous, progressive loss is exhausted, the insured may access multiple layers of excess insurance in any single policy year triggered by the continuous, progressive loss.

The insured need not exhaust each layer of excess insurance horizontally across all policy years before accessing the next layer of excess insurance.

FACTUAL AND HISTORICAL BACKGROUND

Montrose Chemical Corporation manufactured the insecticide DDT in Torrance, California from 1947 to 1982. In 1990, federal and state environmental authorities sued Montrose to recover the cost of cleaning up environmental contamination caused by Montrose's manufacturing facility.

The governments' lawsuit resulted in consent decrees in which Montrose agreed to pay for the environmental cleanup, which ultimately may cost as much as $200 million.

Montrose sought coverage for the cleanup costs under its primary and excess liability policies in effect between 1961 and 1985.

Montrose's efforts to recover from its insurers have resulted in more than a dozen reported decisions, including two previous California Supreme Court decisions clarifying California law on a series of important insurance coverage issues.

One of those decisions, *Montrose Chemical Corp. v. Admiral Ins. Co.*, 10 Cal. 4th 645, 655, 42 Cal. Rptr. 2d 324, 913 P.2d 878, 41 Env't. Rep. Cas. (BNA) 1714 (1995), as modified on denial of reh'g, (Aug. 31, 1995) (*Montrose II*), held that "bodily injury or property damage that is continuous or progressively deteriorating throughout several policy periods" triggers coverage under all policies in effect during those periods. This is known as the "continuous trigger of coverage."

Later, in *State v. Continental Insurance Co.*, 55 Cal. 4th 186, 145 Cal. Rptr. 3d 1, 281 P.3d 1000 (2012), the supreme court clarified several issues it left unresolved in *Montrose II. Continental* held that each triggered policy was potentially liable for the total amount of the loss (subject to their policy limits), regardless of whether a portion of the loss occurred outside the policy's coverage period, and that the insured was entitled to combine or "stack" the limits of all triggered policies.

Largely as a result of these decisions, Montrose was able to resolve its differences with its primary insurers and exhaust the coverage limits of those policies. The issue in this litigation is how and when Montrose can tap its excess insurance policies.

Montrose urged the court to allow vertical exhaustion of excess coverage. Vertical exhaustion allows Montrose to obtain coverage under any excess policy once it has exhausted the policies directly underlying the selected excess for the same policy period.

The insurers, by contrast, argue for horizontal exhaustion of excess coverage. Under horizontal exhaustion, Montrose must exhaust every lower level policy triggered by a continuous and progressive loss before tapping a layer of excess insurance coverage.

POLICY LANGUAGE

Montrose's excess policies all contained language requiring Montrose to "exhaust" the limits of "underlying insurance" before the excess policy is obligated to provide coverage.

Several policies provisions were relevant to what qualified as "underlying insurance" and how Montrose could "exhaust" that insurance."

The policies described "underlying insurance" in four different ways:

(1) Some policies contained a schedule of underlying insurance listing all of the underlying policies in the same policy period by insurer name, policy number, and dollar amount.

(2) Some policies referenced a specific dollar amount of underlying insurance in the same policy period and a schedule of underlying insurance on file with the insurer.

(3) Some policies referenced a specific dollar amount of underlying insurance in the same policy period and identified one or more of the underlying insurers.

(4) Some policies referenced a specific dollar amount of underlying insurance that corresponded with the combined limits of the underlying policies in that policy period.

Critical to the insurers' horizontal exhaustion argument was policy language requiring Montrose to exhaust "other insurance" before it could access the excess policy.

The excess policies described "other insurance" in a variety of ways. For example:

- Some policies provide that they will "indemnify the insured for the amount of loss which is in excess of the applicable limits of liability of the [scheduled] underlying insurance," and then define "loss" as "the sums paid as damages in settlement of a claim or in satisfaction of a judgment for which the insured is legally liable, after making deductions for all recoveries, salvages and *other insurances (whether recoverable or not) other than the underlying insurance and excess insurance purchased specifically to be in excess of this policy.*" (Italics added.)

- Some policies state that the insurer is liable for "the ultimate net loss in excess of the retained limit" and define "retained limit" to mean, among other things, the "total of the applicable limits of the underlying policies listed in [a schedule] [and] the applicable limits of *any other underlying insurance collectible by the insured.*" (Italics added.)

- Under a "Loss Payable" provision, one policy provides it will pay "any ultimate net loss," which is separately defined as "the sums paid in settlement of losses for which the Insured is liable after making deductions for all recoveries, salvages and *other insurance (other than recoveries under the underlying insurance, policies of co-insurance, or policies specifically in excess hereof).*" (Italics added.)

- Under a "Limits" provision, some policies provide that "the insurance afforded under this policy shall apply only after *all underlying insurance* has been exhausted." (Italics added.)

- One policy states that "[i]f *other valid and collectible insurance* with any other insurer is available to the Insured covering a loss also covered by this policy, other than insurance that is in excess of the insurance afforded by this policy, the insurance afforded by this policy shall be in excess of and shall not contribute with such other insurance." (Italics added.)

The insurers argued that these "other insurance" clauses required Montrose to exhaust all other insurance with lower attachment points from every policy period in which environmental damage resulting in liability occurred.

> Key to the court's ruling was its conclusion that the "other insurance" clause language on which the insurers relied does not unambiguously call for horizontal exhaustion.

On cross-motions for summary adjudication, the trial court agreed with the insurers that excess policies attach when Montrose exhausts all lower layer insurance regardless of coverage period, not just the lower layer of insurance within the same policy. The Court of Appeal, Second District affirmed, and the California Supreme Court granted review.

At about the same time, the Court of Appeal for Fourth District disagreed with the result and reasoning of the Second District's opinion in *Montrose.*

In *State of California v. Continental Insurance Co.*, 15 Cal. App.5th 1017, 223 Cal.Rptr.3d 716 (2017), the Fourth District adopted vertical exhaustion as the appropriate method for determining the sequence within which an insured may access excess liability insurance for a continuous, progressive damage.

The supreme court did not grant review in *Continental,* presaging how it would rule in what is likely to become known as *Montrose III.*

MONTROSE III

In *Montrose III,* the supreme court unanimously ruled that the insured "has access to any excess policy once it has

exhausted other directly underlying excess policies with lower attachment points, but an insurer called upon to indemnify the insured's loss may seek reimbursement from other insurers that issued policies covering relevant policy periods."

Key to the court's ruling was its conclusion that the "other insurance" clause language on which the insurers relied does not unambiguously call for horizontal exhaustion.

The court noted, for example, that policy language disclaiming coverage for amounts covered by "other underlying insurance," or require exhaustion of "all underlying insurance" can "fairly be read to refer only to other *directly* underlying insurance in the same policy period that was not specifically identified in the schedule of underlying insurance, anticipating that the scheduled underlying insurance may later be replaced or supplemented with different policies."

Similarly, the court pointed to unintended consequences of insurers' interpretation of the other insurance clauses. The court saw no basis for limiting the insurers' argument to excess insurance policies with a lower attachment point in other policy periods.

The argument could just as easily support the proposition that Montrose must exhaust *every* other insurance policy at *every* attachment, whether that attachment point is above or below that of the excess policy Montrose is seeking to tap.

The court saw the inability of the insurers to cabin their argument as further evidence of their policies' ambiguity.

In addition, the court found nothing in the historical role of other insurance clauses that supports the insurers' horizontal exhaustion argument.

Relying on *Dart Industries v. Inc. v. Commercial Union Ins. Co.*, 28 Cal.4th 1059, 1079, 124 Cal.Rptr.2d 142, 52 P.3d 79 (2002) (*Dart*), the court explained that historically other insurance clauses were designed to prevent multiple recoveries when more than one policy concurrently covered a loss.

They were not understood to dictate a particular exhaustion rule for policyholders seeking to access successive excess insurance policies in cases of long-tail injury.

While finding that the "other insurance" clauses do not speak clearly the question of horizontal v. vertical exhaustion, the court pointed to other policy provisions that are strongly suggestive of vertical exhaustion.

Most excess policies explicitly reference an attachment point, typically by reference to a specific dollar amount of underlying insurance in the same policy period that must be exhausted.

Horizontal exhaustion would preclude Montrose from accessing an insurance policy that, by its terms, kicks in after the specific dollar amount of underlying insurance is exhausted. Relatedly, the excess policies regularly include or reference schedules of underlying insurance — all for the same policy period — that must be exhausted before that excess policy may be accessed.

Under horizontal exhaustion, these schedules would represent only a small fraction of the insurance policies that must be exhausted before a given excess policy may be accessed.

Under California law, ambiguity in an insurance policy is resolved in a manner the protects the "objectively reasonable expectations of the insured." *Minkler v. Safeco Ins. Co. of America*, 49 Cal.4th 315, 321, 110 Cal.Rptr.3d 612, 232 P.3d 612 (2010).

In assessing Montrose's reasonable expectations, the court took a common sense approach, pointing to the adverse practical consequences of horizontal exhaustion for the resolution of coverage disputes and obtaining indemnification.

Montrose's excess policies covered different time periods, provided different levels of coverage, and contained distinct exclusions, terms, and conditions.

Given all these variations across policy periods, a rule of horizontal exhaustion would force insureds to litigate the terms and conditions of policies with lower attachment points in every policy year before accessing policies with higher attachment points, thereby increasing the attachment point of every excess policy in violation of the insured's objectively reasonable expectations.

Moreover, such a rule would pose intractable interpretative problems for courts. For example, how does a court assign a layer to a policy when the limits of each policy increase over time, so that the first layer of excess coverage in 1984 reaches as high as the 13th layer of excess coverage a decade earlier?

Finally, the court dismissed the insurers' fairness argument as a rehash of the same argument the court rejected when it adopted "all sums" allocation in *State v. Continental Insurance Co.*, 55 Cal. 4th 186, 145 Cal. Rptr. 3d 1, 281 P.3d 1000 (2012).

In contrast to "pro rata" allocation, which places the burden of allocating a continuous, progressive loss on the insured, the "all sums" approach allows insureds to control which policy or policies respond to a claim and shifts to the insurers transaction costs associated with allocating a continuous, progressive loss among multiple triggered policies.

Similarly, the *Montrose III* court explained, "the critical difference between a rule of vertical exhaustion and horizontal exhaustion . . . is not whether a single disfavored excess insurer will be made to carry a disproportionate burden of indemnification, but instead whether the administrative task of spreading the loss among insurers is one that must be borne by the insurer instead of the insured."

Vertical exhaustion, like "all sums" allocation, gives priority to ensuring that the insured receives the full benefit of the

insurance bargain and relies on principles of equitable contribution among insurers to ensure that each insurer pays only its share of the loss.

COMMENT

The supreme court's *Montrose III* opinion leaves several questions unanswered, suggesting that the *Montrose* litigation is likely to extend into its fourth decade.

The court distinguished *Community Redevelopment Agency v. Aetna Casualty & Surety Co.*, 50 Cal.App.4th 329, 57 Cal. Rptr.2d 755 (1996), on the ground that it addressed two issues not yet addressed by the supreme court and not before the supreme court in *Montrose III* .

The question in *Community Redevelopment* was whether all primary insurance must be exhausted before a primary insurer may seek contribution from an excess insurer in a case involving continuous loss.

The *Montrose III* court therefore decided only whether lower levels of excess insurance must be exhausted horizontally in a coverage dispute between an insured and its insurer.

The questions of whether vertical exhaustion applies before all primary insurance is exhausted in coverage disputes between insureds and insurers or at all in contribution actions among insurers remain to be resolved.

The court also noted that Travelers Insurance Company has raised issues regarding whether its policies should be construed under Connecticut or New York law, rather than California law, and whether the ruling just enunciated by the California Supreme Court can be applied to the language contained in the Travelers' policies.

Specifically, Travelers noted that Montrose's requested declaration, which would permit Montrose to "seek indemnification" from an excess policy upon establishing that "its liabilities are *sufficient to exhaust* the underlying policy(ies) in the same policy period," is directly contrary to the terms of the Travelers policies, which require *actual* exhaustion before a policyholder may access excess coverage.

Travelers argument implicates the consequences of compromising a coverage dispute with a lower level insurer for less than full policy limits.

A growing number of courts have held that such settlements forfeit the policyholder's rights to recover under excess policies, which typically provide that coverage is triggered when the insured exhausts underlying insurance. *See,* DiMugno, "Insurance Coverage for Financial Catastrophe: Lessons from the Subprime Mortgage Crisis," 36 *Insurance Litigation Reporter* 365, 391-393 (Thomson Reuters July 22, 2014), and the cases cited therein.

Alas, the saga continues.

This article appeared on the Westlaw Practitioner Insights Commentaries web page on June 9, 2020.

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