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California Supreme Court Adopts a Vertical Exhaustion Approach

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In *Montrose Chemical Corp. v. Superior Court,*[1] the California Supreme Court addressed the issue of horizontal exhaustion among excess insurers. This is the third decision by the California Supreme Court from this environmental contamination coverage lawsuit.[2]

Montrose was sued for causing continuous environmental damage between 1947 and 1982. It had manufactured the pesticide dichloro-diphenyl-trichlorethane (DDT) at its facility in California. Montrose was sued by the state and federal government. It entered into partial consent decrees to resolve various claims. Then it sought reimbursement from its liability insurers. For each policy year from 1961 to 1985, Montrose had purchased primary insurance and multiple layers of excess insurance.

Montrose proposed a rule of "vertical exhaustion" or "elective stacking." The insurers proposed a rule of "horizontal exhaustion," meaning that Montrose could only access an excess policy after it had exhausted other policies with lower attachment points for every year in which the environmental damage occurred. The trial court and Court of Appeal had ruled for the insurers. *See Montrose Chem. Corp. v. Superior Court*, 14 Cal. App. 5th 1306, 222 Cal. Rptr. 3d 748 (Ct. App. 2017), *as modified* (Sept. 8, 2017), *rev'd and remanded sub nom. Montrose Chem. Corp. v. Superior Court of Los Angeles Cty.*, 9 Cal. 5th 215, 460 P.3d 1201 (2020). But another Court of Appeal had adopted a vertical exhaustion approach. *State of California v. Cont'l Ins. Co.*, 15 Cal. App. 5th 1017, 223 Cal. Rptr. 3d 716 (Ct. App. 2017).

Ultimately, the Supreme Court agreed with Montrose and held that an insured is entitled to coverage under any relevant policy once it has exhausted directly underlying excess policies for the same policy period. In the context of a continuous loss, the insured does not need to horizontally exhaust all other lower layers of coverage, or policies which attach at a lower dollar level.

The Supreme Court adopted what it articulated as a "vertical exhaustion" theory at the excess level. An insurer who is thus picked to respond to a loss must pay the full loss up to policy limits. It cannot limit its payment to its pro rata share. It may seek reimbursement from other insurers after

that. The insured can pick a second layer excess if the first layer excess underneath it in the same policy year [and other lower layers of coverage] is exhausted, even though first layer excess in other policy years are not exhausted. The insured can go up all layers in one year and let those insurers pursue reimbursement from other excess policies in other years.

The court defined "attachment point" as the level of loss or liability which must be reached before an excess insurer's obligation begins. The excess policies described the underlying insurance in four ways: with a schedule listing all underlying policies; with a stated amount and a schedule of underlying insurance on file with the insurer; with a stated amount and identified of one or more of the insurers; or with a stated amount, which corresponded to the combined limits of the underlying policies.

The parties in their arguments, and the court in its decision, focused on "other insurance" clauses. And the court applied "other insurance clause" broadly to include definitions of ultimate net loss and retained limit as used in insuring agreements; loss payable provisions, limits provisions as well as clauses more traditionally viewed as "other insurance" clauses – those that are titled "Other Insurance." This functional analysis of the policy language looks to see if it acts like an "other insurance" clause, even if it calls itself something else.

First, the Supreme Court noted that other insurance clauses do not mention the effect of coverage in another policy period. It stated that the other insurance language could reasonably be argued to refer to other insurance in other years of coverage. But it could be read the other way as well.

Second, considering the policy as a whole, the court felt that it supported an interpretation that the "other insurance" clauses only referred to policies in the same policy period. The court noted that the other insurance clauses do not specifically state that they apply to insurance in other policy periods. California cases had not adopted such an interpretation.

The other insurance clauses as written could make a policy excess to all other insurance in all other policy years, even if that insurance attached at a higher dollar value. The insurers had only argued that the policies were excess to other policies with lower attachment points. The court found no good explanation why an "other insurance" clause should not be read as limited to policies in the same policy year.

The court found that the traditional use of other insurance clauses was to prevent multiple recoveries. A comment in the Restatement of the Law of Liability Insurance notes that such clauses are generally used to address allocation between overlapping concurrent policies. And most other courts in other states have found that other insurance clauses are *not* aimed at allocation among successive insurers in long-tail injury claims and the sequence in which an insured can access its insurance across several policy periods.

Finally, other language in the policy supported the view the court adopts. Each policy stated an attachment point, which is the amount of directly underlying coverage, not the amount of coverage

in other policy years. Many excess policies considered here include schedules which only list one or more directly underlying policies. These other policy terms support the rule adopted by the court, when the policy is read as a whole.

Third, if the foregoing analysis of the policy language as a whole did not resolve the issue, the court would have resolved the ambiguities to protect the objectively reasonable expectations of the insured. The court noted that application of a rule of horizontal exhaustion would be "far from straightforward." The layers are not uniform. The 1st layer excess in 1984 reached as high as the 13th layer excess in 1974. (Of course, the insurers had not argued for a "layer-by-layer" approach but instead had argued the "bathtub" approach.) The "other insurance" clause in one policy period did not indicate how it should apply to a policy from another period with a lower attachment limit and a higher policy limit. The court felt this undermined the idea that the parties expected horizontal exhaustion to apply.

Finally, there were practical obstacles. An insured and a court would not be able to determine if a given excess policy was triggered without first determining coverage and applicability of exclusions and conditions in all lower-attaching excess policies. This would create more layers of litigation. Further, applying horizontal exhaustion would effectively increase the attachment point. The court reasoned: "Objectively speaking, the parties could not have intended to require the insured to surmount all these hurdles before the insured may access the excess insurance it has paid for."

The court also rejected the insurers' fairness argument. Instead, the court found that the rule it adopts leaves to the insurer the administrative task of spreading the loss among the insurers. In doing so, the court affirmed the right of the excess insurer paying the loss to "seek reimbursement from other insurers that would have been liable to provide coverage under excess policies issued for any period in which the injury occurred." But this leaves open the issue about how those claims will be handled among the insurers: will it be a "fill the bathtub" method or a layer-by-layer method? Probably the former.

In contrast to "other insurance" clauses, there are clauses that do mention the effect of coverage in other policy periods, such as prior insurance clauses, non-accumulation of limits clauses and known-loss endorsements and known-loss language found in policies since *Montrose II* limited the known loss doctrine. Language in *Montrose III* provides some arguments in support of those clauses – prior insurance clauses, non-accumulation of limits clauses and known-loss endorsements and language – because those clauses do explicitly discuss the effect of insurance in other policy periods.

One example of prior insurance and non-cumulation clauses is the "Prior Insurance and Non[-]Cumulation of Liability" provision considered in *In re Viking Pump, Inc.*, 27 N.Y.3d 244, 52 N.E.3d 1144, 1147–48, *opinion after certified question answered,* 148 A.3d 633 (Del. 2016):

> It is agreed that if any loss covered hereunder is also covered in whole or in part under any other excess Policy issued to the Insured prior to the inception date hereof[,] the limit of liability hereon . . . shall be reduced by any amounts due to the Insured on account of such loss under such prior insurance.
>
> Subject to the foregoing paragraph and to all the other terms and conditions of this Policy in the event that personal injury or property damage arising out of an occurrence covered hereunder is continuing at the time of termination of this Policy the Company will continue to protect the Insured for liability in respect of such personal injury or property damage without payment of additional premium.

Such clauses explicitly discuss the effect of insurance not directly underlying the excess policy in the same policy period. Instead these clauses look to policies issued prior to the inception or after expiration of that excess policy. This would arguably avoid the vertical exhaustion rule stated in *Montrose III.*

The Supreme Court distinguished the most-cited horizontal exhaustion case of *California Redevelopment Agency v. Aetna Cas. & Sur. Co.*,[3] as being a contribution action between insurers, not a suit between and insured and its excess insurers. The court noted that in *Montrose III*, all primaries had been exhausted so that horizontal exhaustion of all primary coverage was not an issue. The court stated that the issue was not presented and was not decided whether or when an insured may access excess policies before all triggered primary insurance has been exhausted. As the court wrote: "In sum, we conclude that in a case involving continuous injury, *where all primary insurance has been exhauste*d, ..." (emphasis added).

Notably, the court began its analysis with a discussion of the distinction between primary and excess insurance, highlighting the differences. So, a party can reasonably continue to argue that all primary policies must exhaust before any excess policy must pay. But the issue seems like a somewhat more open issue after this decision.

Of course, before this decision there were qualifications to the rule of horizontal exhaustion. Horizontal exhaustion was the default, but certain language could result in vertical exhaustion being applied to an excess insurer with language that was interpreted to require it to drop down and contribute with primary insurers. And the Court of Appeal decision, which the Supreme Court was reviewing in this opinion, took four exemplars of such language and applied a horizontal exhaustion rule to those.

This decision has more significant practical consequences in a large exposure matter such as a suit seeking damages for remediation of environmental contamination, where an excess insurer, or a tower of excess insurers, might be selected to pay a large environmental contamination loss, and then seek contribution from other excess insurers. The practical consequences are not as significant in a matter involving an aggregate of comparatively smaller claims such as a large number of asbestos bodily injury claims. In those mass tort cases, there will be a continual pursuit of

reimbursement by the insurer selected to obtain contribution as each claim is paid, so it would be unusual for a single loss to involve more than one layer of coverage in the year in question. *Montrose III*, however, was an environmental contamination case, where the loss was approximately $200,000,000 in expenditures and anticipated future liability.

One final note: The court cites the recently published *ALI Restatement of the Law of Liability Insurance*, a Restatement that has not been very popular with some parties, who view it as advocating what the authors think the law **should be** rather that restating what the law **is**.

Endnotes

1 *Montrose Chem. Corp. v. Superior Court*, 6 Cal. 4th 287, 861 P.2d 1153 (1993).

2 See *Montrose Chemical Corp.*, 6 Cal. 4th 287 *(Montrose I)* (extrinsic evidence can be used to establish or defeat a potential for coverage; the fact that the insured's regular business practices involved the disposal of harmful wastes could not eliminate the possibility that at least some of the property damage might have resulted from "accidental" causes covered by the policy); *Montrose Chem. Corp. of California v. Admiral Ins. Co.*, 897 P.2d 1 (Cal. 1995) (Montrose II) (adopts a continuous trigger theory of coverage for cases involving continuous or progressively deteriorating damage; the loss in progress rule does not apply where the insured's liability is still contingent; a potentially responsible party letter did not trigger the loss in progress doctrine).

3 *Cmty. Redevelopment Agency v. Aetna Cas. & Sur. Co.*, 50 Cal. App. 4th 329, 57 Cal. Rptr. 2d 755 (1996), as modified (Nov. 13, 1996).

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