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Vertical Exhaustion and Horizontal Exhaustion

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In "all sums" jurisdictions, like California and Washington, there is a coverage dispute as to whether a horizontal exhaustion or vertical exhaustion approach should apply. That is, does an excess policy attach when the immediately underlying policy has been exhausted? Or does it not attach until all underlying policies triggered by the same occurrence, in prior and subsequent years, have been exhausted. This is not an issue that arises in the many jurisdictions that adhere to a "pro rata" rule. Recently there have been some significant developments in this coverage dispute.

In *Montrose Chemical Corp. v. Superior Court (Montrose III),*[1] the California Supreme Court addressed the issue of horizontal exhaustion among excess insurers. This is the third decision the California Supreme Court concerning coverage for Montrose in environmental contamination coverage lawsuits.[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 state and federal environmental protection agencies. 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". Vertical exhaustion means that Montrose could access an excess policy after it had exhausted directly underlying policies, even if there were policies with lower attachment points in other years in which the

[1] 430 P.3d 1201 (2010).

[2] *See Montrose Chemical Corp. v. Superior Court,* 861 P.2d 1153 (1993) (*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 Chemical Corp. v. Admiral Ins. Co.,* 897 P.2d 1 (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).

environmental damage occurred which had not yet been exhausted. The insurers proposed a rule of "horizontal exhaustion". Horizontal exhaustion means that Montrose could only access an excess policy after it had exhausted all 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 Chemical Corp. v. Superior Court*, 14 Cal. App. 5th 1306 (2017). But another California Court of Appeal had adopted a vertical exhaustion approach. *State of California v. Continental Ins. Co.*, 15 Cal. App. 5th 1017 (2017).

In this case 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 a "vertical exhaustion" theory at the excess level. An excess insurer who is picked by the insurer 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 it has paid. The insured can pick a higher layer excess if all of the lower layer excess policies in the same policy year have been exhausted, even though lower layer excess in other policy years are not exhausted. The insured can elect to 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 115 excess policies described the underlying insurance in four ways:

- with a schedule listing all underlying policies;
- with a stated amount of underlying coverage and a schedule of underlying insurance on file with the insurer;
- with a stated amount of underlying coverage and identification of one or more of the insurers; or
- with a stated amount, which corresponded to the combined limits of the underlying policies.

The parties and the court focused on "other insurance" clauses. The court applied the idea of an "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". If the provision acts like an "other insurance" clause, even if it calls itself something else, the court treated it as an "other insurance" clause.

First, the court observed that other insurance clauses do not mention the effect of coverage in another policy period. The court reasoned that the other insurance language *could* reasonably be argued to refer to other insurance in other years of coverage, but it could just as well be read the

other way around. (That raises the issue of provisions that do mention the effect of coverage in another period, such as prior insurance clauses and non-cumulation of limits clauses.)

Second, reading the language of 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 other insurance clauses do not specifically state that they apply to insurance in other policy periods. Past California decisional law 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. (However, 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 Restatement of the Law of Liability Insurance comment notes that such clauses are generally used to address allocation between overlapping concurrent policies. 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, nor at the sequence in which an insured can access its insurance across several policy periods.

Third, other policy language supported the view that other insurance clauses did not apply to coverage in other policy years. Each policy stated an attachment point, and in doing so referred only to the amount of directly underlying coverage, and did not refer the amount of coverage in other policy years. Many of the excess policies included schedules which only listed one or more directly underlying policies. When the policy is read as a whole, including these other terms, the court held it supported a vertical exhaustion interpretation.

Fourth, if the policy language as a whole did not resolve the issue, the court then would have resolved the ambiguities to protect the objectively reasonable expectations of the insured. The court noted another practical problem. Application of a rule of horizontal exhaustion is "far from straightforward." The layers here were not uniform. The 1st layer excess in 1984 reached as high as the 13th layer excess in 1974.[3] 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 found that this undermined the idea that the parties expected horizontal exhaustion to apply.

[3] Of course the insurers had not argued for a "layer-by-layer" approach (i.e., all first layer excess policies must exhaust before any second layer excess policy would attach) but instead had argued for a "attachment point" approach (wherein an excess policy did not attach until all policies with lower attachment points had exhausted); another approach sometime argues is the "bathtub" approach (where an excess policy does not attach until all policies in all years had spent an amount equal to the excess policy's attachment point; thus if a policy attached at $2,000,000, it would apply when $2,000,000 in coverage has been exhausted in each triggered year, regardless of layers or attachment points.

Finally, there were practical problems. 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 in *all* years of coverage. This would require layers of litigation to sort out those issues. Further, applying horizontal exhaustion would effectively increase the attachment point. "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."[4]

The court also rejected the insurers' fairness argument. Instead, the court found that its rule leaves to the insurer the administrative task of spreading the loss among the insurers. (Of course, the insured has knowledge of and a contractual relationship with its other insurers in other years of coverage; the excess insurer does not have that knowledge and relationship). The excess insurer paying the loss has the right 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."[5][6]

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 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 *Matter of Viking Pump, Inc*., 52 N.E.3d 1144, 1147-48 (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 looks to policies issued prior to the inception or after

[4] *Montrose III, supra*, 460 P.3d at 1213.
[5] *Montrose III, supra*, 460 P.3d at 1203.
[6] Of course that 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 methods or by attachment points.

expiration of that excess policy. This would arguably avoid the vertical exhaustion rule stated in *Montrose III.*

In *SantaFe Braun, Inc. v. Ins. Co. of N. Am.*, 265 Cal. Rptr. 3d 692, 694 (2020) SantaFe Braun, Inc. (Braun) sought coverage for numerous asbestos-related claims under various excess insurance policies. In a 10-year, phased proceeding the trial court entered judgment in favor of the excess insurers based on Braun's failure to establish that the primary and, in some cases, underlying layers of excess insurance had been exhausted. The trial court refused to consider additional evidence of exhaustion presented by Braun almost four years after that evidentiary phase of the trial has been completed. Braun appealed. After this appeal was briefed, the California Supreme Court decided the *Montrose III* case discussed above. The Court of Appeal reversed and remanded, holding that the trial court had abused its discretion in refusing to consider Braun's new evidence of exhaustion.

When asbestos-related claims were first filed against Braun, Braun tendered to its primary insurers. The primary insurers entered into a written agreement with Braun under which the underlying claims would continue to be defended and settled while the primary insurers resolved allocation arrangements among themselves. Eventually the primary insurers entered into an agreement to pay the limits of their policies into a trust which would continue to pay defense costs and claims on behalf of Braun. Certain excess insurers also settled and paid into that trust. In several phases of the trial the trial court found that the excess policies required horizontal exhaustion, and that Braun had failed to prove exhaustion of all of the primary insurance.

The court noted that *Montrose III* expressly left open the issue before the Court of Appeal here: "when the insured has incurred continuous losses extending over the coverage periods in multiple primary policies, whether all primary insurance covering all time periods must be exhausted ('horizontally') before the first level excess policies are triggered, or, as Braun contends, whether coverage under the excess policies is triggered once the directly underlying primary policies specified in each excess policy is exhausted ('vertically')."[7]

The court noted that the language of five policies was comparable to that considered in *Montrose III*. The excess insurers argued that the horizontal exhaustion rule should apply. The insurers notes that this rule is premised on qualitative factors not present in *Montrose III*: "(i) primary policies attach as first dollar coverage and have an immediate obligation to respond; (ii) primary policies receive significantly higher premium and offer lower limits in consideration for greater claims adjustment and defense resources; and (iii) primary coverage has the right to control defense and settlement without input from excess insurers."[8]

The court noted that these qualitative differences are true whether vertical or horizontal exhaustion applies. And the court felt that these qualitative differences did not justify interpreting the policy language differently just because primary coverage in other years had not been exhausted. As to the premium difference the court noted that excess premiums were calculated as a percentage of the primary premium, and this was a straightforward evaluation within one year of coverage, but

[7] *SantaFe Braun, supra,* 265 Cal. Rptr. 3d at 699.
[8] *SantaFe Braun, supra,* 265 Cal. Rptr. 3d at 701.

would be "speculative and unpredictable" if made on the exhaustion of other policies before and after the immediately underlying policy. Further the premium difference between primary and excess did not "justify an interpretation that renders the point of attachment so unpredictable and unascertainable when the policy is issued."[9] As to the defense obligation, an excess insurer has no duty to defend until the scheduled primary exhausts, and the insured could reasonably expect the excess insurer to contribute to the defense once the scheduled primary policy exhausted, and the attachment point had been reached.

In *Gull Indus., Inc. v. Granite State Ins. Co.*, 493 P.3d 1183, 1187 (2021) Gull owned or operated approximately 220 retail gas stations between 1959 and 2005. Gull also owned and operated fuel tanker trucks to deliver gasoline to underground storage tanks (USTs) at its sites. Granite State provided excess insurance with limits of $15,000,000 to Gull from 1980 to 1983. The underlying primary policies provided coverage with limits of $100,000 for general liability in all three years, and $100,000 for auto liability in 1980 (Home) and $500,000 for auto liability in the remaining two years (TIG).

Granite State $15,000,000		Granite State $15,000,000		Granite State $15,000,000	
Home CGL $100K	Home Auto $100K	TIG CGL $100K	TIG Auto $500K	TIG CGL $100K	TIG Auto $500K
1980-81		1981-82		1982-83	

Gull asserted that it faced liability under Washington's Model Toxics Control Account because the releases at some sites resulted in third party property damage; that it has been threatened with lawsuits at 15 sites, received cleanup notifications from regulatory agencies at 19 sites, and has been sued by third parties at 9 sites. Contribution actions were filed by third parties against Gull concerning groundwater contamination at Station 269 (Lynnwood) and Station 272 (Seattle). Gull claimed that "as it typical" there were leaks from USTs, spills from customers overfilling vehicle gas tanks, and spills from the unloading of bulk fuel trucks.

Gull tendered its defense of these actions to TIG. TIG agreed to defend Gull against these actions under a reservation of rights.

Gull sued Granite State and other insurers seeking coverage for its environmental responses costs at all current and former sites.

"Since this action was filed, Gull had received approximately $49 million in settlements and payments. Gull's remediation and investigation costs, as of August 2017, exceeded $17 million, its attorney fees and costs to pursue this action were about $14 million, and its unreimbursed

[9] *SantaFe Braun, supra,* 265 Cal. Rptr. 3d at 701.

defense costs as to all sites were around $274,000. Granite State's coverage obligations remain unresolved on over 100 sites."[10]

The court of appeals first held that the insured has the burden to prove that underlying primary policies are exhausted in order to obtain excess coverage. Gull acknowledged that the TIG primary auto coverage had not been exhausted, and nothing in the record showed otherwise. Unsurprisingly the court held that Gull clearly failed to satisfy its burden on this issue.[11]

Gull next argued that the trial court erred in applying a horizontal exhaustion rule and holding that it must exhaust all available primary coverage, for each year in which it was insured, before Granite State has any excess coverage obligations. The trial court had correctly noted that there was no binding Washington authority on this issue. But the court of appeals noted that the California Supreme Court had recently addressed the issue in *Montrose III*. It discussed the reasoning of *Montrose III* in detail. And it reviewed the *SantaFe Braun* decision which addressed an issue not addressed in *Montrose III* – whether a rule of vertical exhaustion applies when the underlying policies in question were primary policies. *SantaFe Braun* held that a rule of vertical exhaustion applied in that context as well.

The court found the reasoning in *Montrose III* and *SantaFe Braun* and "the application of vertical exhaustion to continuous environmental or asbestos damage claims in those cases is sound and persuasive."[12] The court also agreed with *Montrose III*'s analysis of the parties' reasonable expectations – that once an underlying policy exhausted, excess coverage would apply without the need to litigate the coverage of policies purchased before and after the policy at issue) supports the application of vertical exhaustion herein.

The court then looked at the actual language of the Granite State policies to see if the policy language mandated a different result than vertical exhaustion.

- The "Limit of Liability" provision stated that Granite State would only be liable for the ultimate net loss, the excess of either "the limits of the underlying insurances as set out in the schedule …, or … the self-insured retention …." The policy also provided that if the aggregate limit were reduced or exhausted "by reason of losses paid thereunder" that the excess policy would apply in "excess of the reduced underlying limit" or if the policy were exhausted "continue in force as underlying insurance …."
- The schedule of underlying limits only listed policies in the same year of coverage, not policies in earlier or later years.

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[10] *Gull v. Granite State, supra*, 493 P.3d at 1191.
[11] *Gull v. Granite State, supra*, 493 P.3d at 1192.
[12] *Gull v. Granite State, supra*, 493 P.3d at 1195, and n. 16, citing *Cadet Manufacturing Co. v. American Insurance Co.*, 391 F. Supp. 2d 884 (W.D. Wash. 2005) (district court declined to rule that horizontal exhaustion applied under either Washington law to an excess insurance policy issued by Granite State that was identical in all material respects to the policy here at issue).

- The “other insurance” condition provided that the Granite State policies was "excess of and shall not contribute with" other insurance "other than insurance that is in excess of the insurance afforded by this policy". This did not "identify any other specific primary insurance that Gull must exhaust in order to trigger Granite State's excess coverage."[13]
- The definition of "ultimate net loss" "simply says Granite State will not pay for expenses included in other 'valid and collectible' insurance. But when looking at the policies as a whole, …, the only valid and collectible insurances … are those set forth in the schedules attached to each … policy. This provision does not suggest that horizontal exhaustion is required herein."[14]

The court concluded that no provision in the excess policies "expressly requires horizontal exhaustion of primary policies issued over a variety of policy periods".[15] And the court also relied upon the reasonable expectation analysis: "because a reasonable person would read Granite State's policies to mean that Gull may access excess coverage upon exhausting the schedule of underlying primary coverage during the same policy period, we conclude that the rule of vertical exhaustion applies to this case. Both the policy language and the principles explained in *Montrose* and *SantaFe* lead to this conclusion."[16]

The court then turned to the specific policies at hand. All parties agreed that TIG had exhausted its CGL coverage, and had not exhausted it auto liability coverage at all sites. Gull argued that Granite State should apply since it was excess of the exhausted CGL coverage.

The trial court had found that Granite State attached at $1.6 million using its horizontal exhaustion analysis and stacking both the CGL and auto liability limits. With a vertical exhaustion analysis the question became whether Granite State attached at $100,000 (the CGL limit) or at $600,000 (the combined limits of the CGL and auto coverage).

Gull argued that the CGL and auto were distinct coverages covering distinct risks and therefore not "other insurance" vis-a-vis each other. Gull argued that a petroleum release from its driver's action in filling USTs from a tanker truck was an "accident" that triggered the auto liability policies, but that a release from a leaking UST constitutes an "occurrence" triggering the CGL policies. Thus, Gull argued, primary coverage for damage from leakage from tanks and pipes is exhausted, and that, therefore, the Granite State excess coverage as to that risk must be triggered.[17]

Granite State replied that Gull claimed that indivisible property damage was caused by its general and automobile operations, and that both Gull and its insurers were jointly and severally liable for all remediation costs. Therefore, Granite State argued, the CGL and auto liability policies covered the same risk. The court rejected this argument finding that it conflated “risk” with the type of loss

[13] *Gull v. Granite State, supra*, 493 P.3d at 1196.
[14] *Gull v. Granite State, supra*, 493 P.3d at 1196-97.
[15] *Gull v. Granite State, supra*, 493 P.3d at 1197.
[16] *Gull v. Granite State, supra*, 493 P.3d at 1197.
[17] *Gull v. Granite State, supra*, 493 P.3d at 1198.

or damage that resulted, but "risk" and "loss" are different concepts. The "risk" is "'the category of loss the insurer agreed to provide cover under the terms of the policy.'"[18] But the "loss" is an undesirable outcome of a risk, it is a product of a risk.

However, the excess policy language controls here, not the primary policy language. The policies state that the excess insurer is liable for "each occurrence covered by said underlying insurances." In turn it defined "occurrence" as "a continuous or repeated exposure to conditions that results in property damage. However, the excess policy further provided that all such exposure to conditions "existing at or emanating from one premises location shall be deemed one occurrence." "Thus, the excess policy itself defines as one occurrence that which is two different risks where referenced in the underlying policies. Because the limits of the underlying policies that covered this occurrence have not been both exhausted as to all sites, Granite State's excess obligation is not triggered."[19]

Thus, Granite State's policy would be triggered by exhaustion of the TIG CGL policy ($100,000) and payment of $500,000 under the auto liability policy, resulting in an attachment point of $600,000 in any policy period, under the vertical exhaustion approach. The matter was remanded to determine if additional costs at one site had exceeded this attachment point in the six years since the trial court had found that the insured incurred and paid remediation costs of $325,818, and would incur future costs at that site. And the matter was remanded to the trial court to determine whether part of a $6.4 million settlement of all claims between Gull and TIG had been allocated to two other sites so as to reach the attachment point at those two sites. "Thus, if Gull can establish that at least $500,000 of the $6,400,000 was attributable to property damage arising from activity at Station 269 [and Station 272], Granite State's policy obligations will be triggered because the situation will be that which it bargained for in its policy."[20]

This dispute between horizontal and vertical exhaustion is a dispute that arises in "all sums" jurisdictions, like California and Washington. It does not arise in the many jurisdictions that adhere to a "pro rata" rule. As can be seen in *SantaFe Braun* and *Gull*, many of these cases also involve a significant evidentiary fight over whether the insured can prove that it has exhausted the underlying coverage. That can involve issues of how a release of all claims – such as between Gull and TIG – is allocated to certain policy years and to certain cites.

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[18] *Gull v. Granite State, supra*, 493 P.3d at 1199 (citations omitted).
[19] *Gull v. Granite State, supra*, 493 P.3d at 1200.
[20] *Gull v. Granite State, supra*, 493 P.3d at 1201.