

## CONTRACTUAL RISK TRANSFER: PRIORITY OF COVERAGE – VERTICAL OR HORIZONTAL EXHAUSTION

**Insurance requirements contained in construction contracts typically include terms that dictate the priority of coverages available to the insured parties. Recent court cases (particularly the *Kajima* case in Illinois) have challenged insureds, carriers and brokers by interpreting policies differently than many had expected. These cases impact the way policies respond when one party to a contract requires another to provide additional insured coverage, with the expectation that a portion of that additional insured coverage will be satisfied under an umbrella/excess policy.**

The priority in which coverage is applied under these circumstances is frequently described in terms of “vertical” or “horizontal” exhaustion. Contract terms generally require vertical exhaustion, where the umbrella/excess follows the primary additional insured coverage. However, many states have recognized a different approach – horizontal exhaustion – when determining the priority of coverage in these circumstances.

**How separate insurance programs interact in the event of a loss is critical to ensuring compliance with the contract. The potential for confusion is illustrated through the following example.**

- Contracted parties agree that the downstream party will provide the upstream party with \$10M of additional insured coverage for Commercial General Liability (CGL) losses on a primary/non-contributory basis. The parties further agree that the terms of the additional insured coverage will be subject to ISO forms CG 2010 1001 and CG 2037 1001, or equivalent language.
- Contract terms allow for the downstream party to satisfy a portion of the additional insured requirement with umbrella/excess coverage.



- The certificate of insurance shows \$2M in primary CGL coverage and \$8M of umbrella/excess coverage, and certifies that additional insured coverage is afforded subject to the agreed endorsement language.

The parties are satisfied that the additional insured coverage is consistent with contractual requirements, in part, because the umbrella/excess is generally follow-form coverage and the appropriate additional insured endorsements are in hand.

It seems clear – until a loss occurs:

- A Commercial General Liability loss of \$5M arises out of the downstream party’s work. A suit is filed against the upstream party.
- The upstream party seeks additional insured coverage from the downstream party’s primary CGL carrier. The carrier grants coverage, provides for defense and agrees to indemnify up to the \$2M primary limit.
- The downstream party’s umbrella/excess carrier is placed on notice with the expectation that it will provide additional insured coverage for the remaining \$3M of loss.

The umbrella/excess carrier acknowledges that the upstream party is afforded coverage as an additional insured (following-form). However, citing “other insurance” provisions contained in the umbrella/excess policy, the carrier maintains that its coverage is excess over other collectible insurance – including coverage afforded to the upstream party under its CGL practice policy (as a named insured).

Even if the contracted parties agree that the umbrella/excess carrier is wrong, the carrier may get its way for two reasons:

## REASON #1: OTHER INSURANCE PROVISIONS

Comparison of the “other insurance” provisions contained in the downstream party’s umbrella/excess versus those contained in the upstream party’s CGL practice policy may result in the latter being deemed primary, contrary to the terms of the contract.



## REASON #2: APPLICABLE LAW

The law may recognize the principle of horizontal exhaustion, where all primary coverage must be exhausted before the umbrella/excess coverage applies. The law may ignore the clear intent of contracted parties as well as umbrella/excess policy language stating that the umbrella/excess coverage will apply when the scheduled underlying policy is exhausted (with the scheduled underlying policy being the downstream party’s primary CGL).

**The law that applies to umbrella/excess policies in these circumstances varies by state. (Note: the applicable law is not necessarily the law of the state in which the loss occurred). Many states have yet to address the issue. For those that have, the majority recognize a horizontal exhaustion approach. A minority of states recognize vertical exhaustion or other principles that would apply the coverage as intended by the parties.**

While the importance of this issue for the upstream party is obvious, the downstream party must also be aware of breach of contract exposure, for which there may be limited or no insurance coverage.

This issue has generated significant discussion on strategies to mitigate the exposure and increase the likelihood that coverage will be applied as expected by the contracting parties. Each strategy brings challenges:

- Require higher primary limits or disallow use of umbrella/excess coverage to satisfy the additional insured requirements.

**Challenge:** Insurance market limitations or prohibitive costs.

- Verify that umbrella/excess coverage will apply on a non-contributory basis when the downstream party’s primary CGL is exhausted, most likely via amendment to the other insurance provisions contained in the umbrella/excess policy.

**Challenge:** Possible resistance from umbrella/excess markets, particularly after placement. Appropriate coverage specifications/negotiations are required at time of placement on behalf of the downstream party, something that may be dependent on the experience of the placing broker/agent.

- Amend the other insurance provisions contained in the upstream party's CGL practice policy so as to apply coverage as excess over all other available additional insured coverage, whether primary, excess or contingent. Partner with the underwriter to seek the best available language.

**Challenge:** Even the best of language may result in application of concurrent excess coverage between the policies, possibly resulting in a pro-rata sharing method.

- Ensure that contractual indemnity provisions are appropriate and enforceable and consider tender of the claim via indemnity provisions, which would not be hindered by other insurance provisions.

**Challenge:** Many states recognize anti-indemnity laws, which may limit or otherwise prevent successful tender of the loss. If allowed, tender based on contractual indemnity can move more slowly, particularly on defense obligations.

The first step in making sure your coverage applies as you intend is to understand the possibility that the law may hold a different opinion. You may want to engage an insurance adviser to help you sort through the details of this complex issue.

## CONTACT

**Frank Armstrong**

Director of Construction Claims  
813 490 6813  
frank.armstrong@willis.com

<sup>1</sup> *Kajima Construction Services, Inc. v. St. Paul Fire and Marine Insurance Company*, 227 Ill. 2d 102 (2007).

*Willis HRH is the leading construction broker in the world. With more than 650 construction Associates in North America in 200 offices, we offer unparalleled expertise to the construction industry locally, nationally and globally. Our clients range from local contractors to international integrated firms.*