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California Supreme Court Adopts "Vertical Exhaustion" in the Long-Storied Montrose Environmental Coverage Litigation

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On April 6, 2020, the California Supreme Court issued a decision that held a policyholder is entitled to access available excess coverage under any excess policy once it has exhausted directly underlying excess policies for the same policy period in *Montrose Chemical Corporation v. the Superior Court of Los Angeles County,* Supreme Court of California, case number S244737. In its unanimous decision adopting this "vertical exhaustion" requirement, the court rejected the "horizontal exhaustion" rule urged by the policyholder's excess insurers, under which the policyholder would have been able to access an excess policy only after it had exhausted other policies with lower attachment points from every policy period in which the environmental damage resulting in liability occurred.

In 1990, Montrose sought coverage under primary policies and multiple layers of excess policies issued for periods from 1961 through 1985 for environmental damage liabilities arising from its production of insecticide in the Los Angeles area between 1947 and 1982. The ongoing dispute currently arises out of Montrose's Fifth Amended Complaint which was filed in 2015 seeking declarations concerning exhaustion and the manner in which Montrose may allocate its liabilities across the policies. Each of the excess policies at issue contained a requirement of exhaustion of underlying coverage. The various policies described the applicable underlying coverage in four main 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; and (4) some policies referenced a specific dollar amount of underlying insurance that corresponds with the combined limits of the underlying policies in that policy period. The excess policies also provided, in various ways, that "other insurance" must be exhausted before the excess policy can be accessed.

Montrose and the insurers disagreed if those "other insurance" clauses required Montrose to exhaust other insurance coverage from other policy periods. Montrose argued for a "vertical exhaustion" rule under which it could access excess policies in any given policy period once it had exhausted the immediately underlying policies in that period. The insurers, on the other hand, argued for a "horizontal exhaustion" rule under which Montrose would be required to exhaust every lower level excess policy covering the triggered years before accessing an excess policy.

The trial court ruled in favor of the insurers, holding that, in the context of multiyear injury, the excess policies required horizontal exhaustion. In a 2017 decision, the Court of Appeals agreed with the trial court, holding that the plain language of many of the excess policies purchased by Montrose provide that they "attach not upon exhaustion of lower layer policies within the same policy period, but rather upon exhaustion of all available insurance." *Montrose Chemical Corporation v. Superior Court*, 14 Cal.App.5th 1306, 1327 (2017).

A short time later, however, the Court of Appeals reached a contrary conclusion in a different case, holding that vertical exhaustion was appropriate. *State of California v. Continental Ins. Co.*, 15 Cal.App.5th 1017 (2017). The California Supreme Court granted review "to determine whether vertical exhaustion or horizontal exhaustion is required when continuous injury occurs over the course of multiple policy periods for which an insured purchased multiple layers of excess insurance." (Op. at 8).

The Supreme Court began its analysis by reviewing the principles applicable to long-tail environmental claims where damage occurs over multiple policy periods. The court noted that California follows an "all-sums-with-stacking" approach to such claims, under which: (1) the continuous trigger applies in such cases; (2) California follows the "all sums" rule; and (3) the insured may seek indemnification from every policy that covered a portion of the loss, up to the full limits available under each policy.

Turning to the question of the order in which an insured can access excess policies from different policy periods to cover liability arising from long-tail injuries, the court observed that the plain language of the policies' various "other insurance" clauses was not adequate to resolve the dispute in the insurers' favor. The court held, among other things, that "the 'other insurance' clauses at issue clearly require exhaustion of underlying insurance, but none clearly or explicitly states that Montrose must exhaust insurance with lower attachment points *purchased for different policy periods*." (Op. at 17, emphasis in original). The court also observed that, historically, other insurance clauses were intended to prevent multiple recoveries when more than one policy provided coverage for a particular loss, not "as dictating a particular exhaustion rule for policyholders seeking to access successive excess insurance policies in cases of long-tail injury." (Op. at 18). "[M]ost courts to address the issue," the court wrote, "have found that 'other insurance' clauses are not aimed at governing the proper allocation of liability among successive insurers in cases of long-tail injury or the appropriate sequence in which a policyholder may access its insurance across several policy periods." The court further noted that other provisions of the policies, such as the fact that the policies state their attachment points only in terms of the immediately underlying insurance, "strongly suggest that the exhaustion requirements were meant to apply to directly underlying insurance and not to insurance purchased in other periods." (Op. at 21).

The court concluded:

In sum, the "other insurance" clauses do not clearly specify whether a rule of horizontal or vertical exhaustion applies here. Read in isolation, the "other insurance" clauses might plausibly be read to perform the function the insurers ascribe to them. But read in conjunction with the actual language of other provisions in the policies, and in light of their historical role of governing allocation between overlapping concurrent policies, the insurers' reading becomes less likely. Rather, in the absence of any more persuasive indication that the parties intended otherwise, the policies are most naturally read to mean that Montrose may access its excess insurance whenever it has exhausted the other directly underlying excess insurance policies that were purchased for the same policy period.

(Op. at 22-23).

Finally, the court held that, to the extent any of the language of these policies remains ambiguous, consideration of the parties' reasonable expectations favors a rule of vertical exhaustion rather than horizontal exhaustion. The court, however, noted that the parties "are, of course, free to write their policies differently to establish alternative exhaustion requirements or coverage allocation rules if they so wish." (Op. at 28).

While the *Montrose* case is moving into its fourth decade, it is not yet over. At a minimum, as noted in the recent decision, Travelers Insurance Company has raised issues as to whether its policies should be construed under Connecticut or New York law, rather than California and whether the ruling just enunciated by the California Supreme Court can be applied to the language contained in the Travelers' policies. Alas, the story continues.

If you have questions or would like further information, please contact Greg Capps (cappsg@whiteandwilliams.com; 215.864.7182) or another member of the Insurance Coverage and Bad Faith group.