NY Rulings Show Shift In Insurance Priority Approach

By **Dan Kohane** (March 28, 2023)

Dan Kohane

Risk transfer is such an important part of civil litigation.

The interrelationship between additional insured status and trade contractual indemnity is a compelling part of labor law and construction litigation in New York and in other jurisdictions.

What is the proper approach for courts to follow when considering the application of primary and excess policies and contractual indemnity claims?

In several recent cases, New York courts have been suggesting that courts should look to the intention of the parties — as reflected in indemnity and hold harmless agreements — to determine coverage priority, a concept often referred to as vertical exhaustion.

These recent decisions run contrary to clear policy language and include: a New York state court's February decision in Scottsdale Insurance Co. v. Mt. Hawley Insurance Co.; a New York state appeals court's 2019 decision in Arch Insurance Co. v. Nationwide Property & Casualty Insurance Co.; and the U.S. Court of Appeals for the Second Circuit's 2021 decision in Century Surety Co. v. Metropolitan Transit Authority.

Insurance policies are insurance policies and trade contracts are trade contracts. While they both may have impact on the eventual payment of settlement of verdict proceeds, they must be considered independently.

New York has traditionally held where there are claims of primary and excess coverage that all primary policies are exhausted before excess policies and insurance policy provisions control the priority of coverage, not the provisions of trade contracts between the parties.

Under well-established case law, courts analyze policy language separately and distinctly from trade contract indemnity agreements and insurance priority determined by the policies.

New York's Appellate Division cites that New York's highest court held in its 1985 decision in State Farm Fire & Casualty Co. v. LiMauro that it is the policy provisions that control and not the provisions of the subcontract.[1]

That decision and many others represent the concept of horizontal exhaustion — primary policies come before excess or umbrella policies.

Lately, however, some courts are reexamining that approach. They are looking at vertical exhaustion.

Vertical exhaustion suggests that primary and excess policies purchased by the parties down the contractual food chain are required to spend their limits before any policies purchased by the upstream parties. The concept of vertical exhaustion is that the trade contract parties expect lower-tier parties to be responsible for the losses and, therefore, the courts should look to that intent when deciding priority of coverage.

On Feb. 6, the New York Appellate Division, First Department, gave silent blessing to vertical exhaustion in its decision in Scottsdale Insurance v. Mt. Hawley Insurance.[3]

In Scottsdale, the owner — 175 Broadway Hospitality — hired Dome Voyagers LLC as general contractor for a construction project. The general contractor was to indemnify the owner and provide it with additional insured coverage.

The owner had a primary commercial general liability policy with a $1 million limit with certain underwriters at Lloyd's, London. The owner had an excess policy with a $3 million limit with Mt. Hawley.

The general contractor had a primary policy with First Mercury Insurance Co. with a $1 million limit and an excess policy with Scottsdale with a $10 million limit.

After an underlying personal injury case settled with First Mercury paying $1 million and Scottsdale paying the balance of $2.275 million, Scottsdale sought reimbursement from Mt. Hawley and Lloyd's. Scottsdale argued that the horizontal exhaustion rule required the exhaustion of the owner's policies before the downstream policies from the general contractor.

The court recognized that the horizontal exhaustion rule mandates that all primary policies be exhausted before excess coverage is triggered but found that the rules governing priority of coverage were inapplicable here.

At the end of the day, the appellate court jumped over the policies issued to the owner and held that "[s]ince the owner (175 Broadway Hospitality) was entitled to contractual indemnification from the general contractor (Dome) due to a complete pass-through of liability, the excess policy issued to Dome must respond before the primary and excess policies issued to 175 Broadway Hospitality."[4]

In substance, the court tried to ascertain the intent of the parties by considering the indemnity and hold harmless agreements. Concluding that the owner was entitled to a complete pass-through via the indemnity agreement, it, in effect, jumped over the primacy analysis required in horizontal exhaustion and decided coverage primacy not on a strict policy review but on the intentions, reflected in the indemnity agreement.

The court cited its 2019 decision in Arch Insurance v. Nationwide,[5] and its 2010 decision in Indemnity Insurance Co. of North America v. St. Paul Mercury Insurance Co.[6]

The court so held despite recognizing that "New York's horizontal exhaustion rule mandates that all primary policies be exhausted before excess coverage is triggered," citing to well-established case law, including a New York state court's 2008 decision in Bovis Lend Lease LMB Inc. v. Great American Insurance Co.:

> An insurance policy is a contract between the insurer and the insured. Thus, the extent of coverage (including a given policy's priority vis-à-vis other policies) is controlled by the relevant policy terms, not by the terms of the underlying trade contract that required the named insured to purchase coverage.

The Bovis court went on to say that "'it is the policy provisions that control (priority of coverage) and not the provisions of the subcontract' between the insureds."[7]

The court recognized in Bovis that the trade contract did not govern the primacy established by the policy language.

A later determination based on trade contract indemnity may shift the eventual responsibility for reimbursement or indemnity.

The court in the Scottsdale case scoffed at the horizontal exhaustion rule, citing its 2010 decision, Indemnity Insurance, where it held that the priority of coverage was irrelevant, looking to the indemnity agreement between the parties to determine primacy, finding no merit to the argument that the primary policies must be exhausted before considering the excess policies — the hallmark of horizontal exhaustion.

Instead, the court concluded that priority was irrelevant because the indemnity agreement shifted ultimate liability. Indeed, the court noted, in that case, it was particularly so because the downstream party had accepted the defense and unconditionally and without reservation agreed to indemnify the additional insured.

Would the result have been different if the defense had not been accepted without reservation? Would the result have been different if there had been evidence of negligence on the part of the additional insured that could not be passed through the indemnity agreement because of the restrictions imposed by New York General Obligations Law Section 5-322.1?

In its 2019 Arch Insurance decision where the court followed the same approach, it held:

> Since Owners were entitled to contractual indemnification from S&J and a complete pass through of liability, the Nationwide umbrella policy issued to S&J must respond before the Arch primary policy issued to Owners.[8]

In 2021, an unreported Second Circuit decision in Century Surety v. Metropolitan Transit Authority predicted that the Court of Appeals would adopt the holdings set forth in Indemnity and Arch — that an indemnity agreement in the underlying trade contract between insureds governs over the terms of an insurance policy concerning priority of coverage.[9]

In that case, again, the court applied vertical exhaustion by assuming the applicability of the indemnity and hold harmless agreement, a contract that had not yet been litigated.

To demonstrate the interrelationship between the two forms of risk transfer, a review of a 2007 Fourth Department case is in order.

In the U.S. District Court for the Southern District of New York's 2010 decision in Harleysville Insurance Co. v. Travelers Insurance Co., Travelers insured the general contractor under a primary policy and an excess policy.[10]

The subcontractor, the plaintiff's employer, was W.C. Roberson Plumbing, insured by Harleysville under two policies — a primary and an excess policy. Savarino was added as an additional insured under the Harleysville primary policy but not the Harleysville excess policy. The verdict in the case was approximately $3 million.

The Fourth Department held that comparing the other insurance clauses on the primary Harleysville and Travelers policy, the additional insured coverage under the Harleysville policy was the first to pay, followed by the only other primary coverage providing that level

of coverage to Savarino, its own primary policy with Travelers. Both policies had $1 million in liability limits.

The court then held that the next policy in line for the main-line defendant, Savarino, was its own excess policy with Travelers, rather than look to the intent of the parties.

That is the essence of horizontal exhaustion. That decision resolved the coverage analysis.

Then, the court held that the next step in risk transfer was to examine the trade contracts to see if Travelers could be reimbursed for the amount it paid under its excess policy.

It could — not because of intent — but because of the impact of the indemnity agreements to shift the risk of loss.

Since Savarino was granted summary judgment in the underlying action on its cause of action for contractual indemnification, Travelers would therefore have a right of subrogation against Roberson in that third-party action.

Accordingly, as a practical matter, it would be entitled to reimbursement from Roberson for the amount that Travelers is obligated to pay plaintiff as excess coverage for Savarino's liability to Roberson's employee.

Horizontal exhaustion is consistent with well-established insurance concepts: Primary policies are indeed designed to be spent down first and excess or umbrella policies are intended to follow primary policies.

If the trade contract partners — the owners and general contractors, the general contractors and subcontractors, etc. — wish to shift the responsibility between and among them, they can do so by trade contract indemnity agreements, which can be enforced according to their terms and subject to any limitations that may exist in their enforcement under the General Obligations Law, e.g., Section 5-322.1.

Extrinsic evidence of intent should not trump clear policy language.

Dan D. Kohane is a senior member and head of the insurance coverage and extra contractual liability practice group at Hurwitz Fine PC.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of their employer, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] State Farm Fire & Cas. Co. v. LiMauro, 65 N.Y.2d 369, 492 N.Y.S.2d 534, 482 N.E.2d 13 (1985).

[3] Scottsdale Insurance Company v. Mt. Hawley Insurance Company, 2023 NY Slip Op 00641 (2/6/23).

[4] Id.

[5] Arch Ins. Co. v Nationwide Prop. & Cas. Ins. Co., 175 AD3d 437, 438 [1st Dept 2019].

[6] Indemnity Ins. Co. of N. Am. v St. Paul Mercury Ins. Co., 74 AD3d 21, 26 [1st Dept 2010]).

[7] Bovis Lend Lease LMB, Inc. v Great Am. Ins. Co., 53 AD3d 140, 145 [1st Dept 2008].

[8] Arch Insurance, supra, citations omitted.

[9] Century Sur. Co. v Metro. Tr. Auth., 20-1474-CV, 2021 WL 4538633, at *3 [2d Cir Oct. 5, 2021].

[10] Harleysville Ins. Co. v. Travelers Ins. Co., 2007 NY Slip Op 2378, 38 A.D.3d 1364, 831 N.Y.S.2d 625 (App. Div.).