

WHO'S ON FIRST? JOSTLING FOR POSITION WHERE COVERAGE IS PROVIDED BY MORE THAN ONE POLICY

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INTRODUCTION

Apportionment of risk has always been a consideration in virtually any contractual engagement. Whether the contract is for the construction of a building, the operation of a hotel or resort, or the delivery of fuel to a utility, or a supply contract between a retailer and a vendor – to name just a few examples – attempts are made in the bargaining stage to create a system for the allocation of responsibility for anticipated potential liabilities.

It was not that long ago that the contractual device for allocating risks between the parties were indemnification provisions in engagement contracts, along with a requirement that a contracting party maintain adequate insurance of its own. Generally speaking, indemnification provisions sought to limit a contracting party's vicarious liability for the negligence of the other party. Proof of satisfaction of a contractual requirement of adequate insurance usually was demonstrated by the provision of certificates of insurance, which plainly state that they are not insurance themselves and do not alter the terms or conditions of the insurance policy itself.

Beginning in the mid-1980's, however, the Insurance Services Office began publishing endorsements modifying the definition of an "insured" in a CGL policy in such a way as to broaden the definition to include as an insured a person or organization named in a schedule of additional insureds. Coverage was available to those additional insureds for liability arising out of the original named insured's work "by or for" for that additional insured. Soon thereafter, large companies began including contractual requirements to the effect that they be named as an additional insured in their vendor's own insurance policies. The American Institute of Architects' decision to include such a provision in its stan-

¹ The statements and opinions expressed in this paper are solely those of the author, and do not constitute the position of Jackson & Campbell, PC or any of its clients.

dard form contracts for construction projects was largely responsible for the rapid proliferation of such provisions in the construction industry. Now, it is unusual for construction, management, and large vendor contracts not to include such additional insured provisions. Meanwhile many contracts continue to contain their own separate indemnification agreements, unrelated to the insurance provisions.

Adding to the proliferation of potential insurance coverage is the advent of “owner-controlled insurance programs” and “wrap-up” insurance by which the owner of a construction project obtains CGL coverage for itself and all of the contractors and sub-contractors engaged in the project. Such insurance typically is limited to liabilities arising from the construction of the project.

The upshot of all this is that with increasing frequency, we find situations in which more than one carrier must respond to a given loss on behalf of the same policyholder. The issue then becomes, as our title suggests, which insurer takes priority in responding to the insured’s claim? This, in turn, brings into play two main issues. First, how do the courts allocate or decide between insurance policies, in terms of applying the policy language of those policies themselves, to answer this question? Second, how do separate indemnification provisions affect this analysis, if at all?

FACT PATTERN

Let us assume that Galaxy Electric Generating Company, an Illinois corporation, owns a number of power plants which generate electricity from natural gas and oil. It also owns a pipeline which can be used to transport either kind of fuel from a transshipment dock on the Chesapeake Bay to one of its power plants located in Virginia. On April 1, 2003, a large explosion in the pipeline caused significant property damage to structures in the town of Freedomia, Virginia. Fortunately no one was injured, but numerous private property owners, and the Environmental Protection Agency as well as state and local governmental agencies brought suit against GEGCO.

The pipeline was operated by the Chico Pipeline Management Group, also an Illinois corporation, under contract to GEGCO. During the course of a routine inspection of the interior of the pipeline using a “smart pig” the pig reached a pocket of trapped natural gas and the instruments on the pig were thought to have caused the explosion. The interior of the pipeline was to have been cleaned of natural gas by a shipment of fuel oil prior to the inspection operation, but the pipeline’s instruments for measuring oil pressure, rate of flow and volume were not in proper calibration at the time of the fuel oil shipment. The incorrect

instrument readings resulted in lower fuel oil pressure that was needed to insure complete evacuation of the natural gas, which in turn resulted in a trapped pocket of natural gas which remained in the pipeline for the pigging operation. CPMG's operations had been under the supervision and, at times, direction of GEGCO, and in any event responsibility for the maintenance of the pipeline and its appurtenances, including the instruments, was GEGCO's.

GEGCO and CPMG had their own separate insurance for this loss. Due to the nature of their business, environmental claims directly arising from their fault in the operation of the pipeline were covered (subject to a large SIR) and the property damage claims of neighboring residents in Freedonia also were covered. GEGCO had \$5 million in primary coverage with Pole Star Insurance Company, and \$50 million in excess coverage provided by Andromeda Casualty Company. CPMG had \$2 million in primary coverage with Haddock Insurance Company and \$25 million in excess coverage from Rock Solid Accident & Casualty Company. In accordance with a provision in their pipeline operations agreement between GEGCO and CPMG, GEGCO was named as an additional insured under the CPMG primary and excess policies. Finally, all of the insurance for both policyholders was negotiated, issued and paid for in Illinois.

Various individuals and groups of neighboring property owners sued shortly after the accident claiming a total of some \$75 million in damages. Pole Star and Haddock assumed the defense of their insureds under reservations of rights, and later settled on behalf of their respective insureds with one group of plaintiffs for \$4 million. CPMG's contribution to the settlement was \$2 million, which all parties agreed exhausted Haddock's indemnity limit. Pole Star and Rock Solid then continued defending their insureds in the remaining matters.

The Pole Star policy contained the following "Other Insurance" clause:

Other Insurance

This agreement is primary insurance. If there is any other valid and collectible insurance for injury or damage covered by this agreement, the following applies in connection with that other insurance:

Other primary insurance. When there is other primary insurance, we will share with that insurance the amounts you are legally required to pay as damages for injury or damage covered by this agreement. We will do so in accordance with the methods of sharing described below.

However, the coverage provided by this agreement will apply as excess insurance over that part or parts of any other insurance which provide:

- Property or similar coverage for property damage to your work;
- Property or similar coverage for property damage to premises you own, rent or occupy;
- Aircraft, auto or watercraft bodily injury or property damage coverage; or
- Protection for you as an additional insured if you agree that we may apply this agreement as excess insurance.

Methods of sharing

Contribution by equal shares. If all of the other insurance permits contribution by equal shares, we will share the damages equally. But we will not pay more than the limits of coverage that apply under this agreement. If any policy reaches its limit before the entire amount of damages is paid, the remaining policies will share the balance equally until their limits have been used up or the amount of the damages is paid in full

Contribution by limits. If any of the other insurance does not permit contribution by equal shares, we will pay that portion of the damages which is equal to our percentage of the total of all limits that apply. But we will not pay more than the limits of coverage that apply under this agreement.

Both the Andromeda and Rock Solid excess policies contained identical “other insurance” conditions, which read as follows:

Other Insurance

If other valid and collectible insurance applies to a loss that is also covered by this policy, this policy will apply excess of the other insurance. However, this provision will not apply if the other insurance is specifically written to be excess of this policy.

Finally, the contract between GEGCO and CPMG providing for pipeline operations included the following provision:

Mutual Indemnification

- a. Operator [CPMG], its agents and employees, shall not be liable to Owner [GEGCO] or to any other person for any act or omissions, negligent, tortuous or otherwise, of any agent or employee of Owner or Operator in the performance of this Agreement, except that this provision will not apply to any such liability arising from any fraud, willful misconduct or gross negligence of Operator, its employees or agents. Owner hereby agrees to indemnify and hold harmless Operator, its agents and employees, from and against any such liability, loss, damage, cost or expense (including attorneys' fees) by reason of any such act or omission which is covered by the preceding sentence.
- b. Operator shall indemnify and hold harmless Owner, its agents and employees, from and against any liability, loss, damage, cost or expense (including attorneys' fees) arising from any fraud, willful misconduct or gross negligence of Operator, its agents and employees.

At a settlement conference with a large group of remaining plaintiffs, GEGCO, CPMG and their remaining insurers collectively believe that they can successfully negotiate a settlement in the range of \$14 million to \$16 million. Their internal issue that has to be resolved before an offer can be made is to determine, as between the two lines of coverage, a method of sharing the settlement amount. In entering this negotiation, all insurers concede for purposes of settlement that both insureds have some degree of liability and are joint tortfeasors, and that the availability of coverage *per se* is not disputed.

ANALYSIS

At this juncture we know that Pole Star (with \$2 million in remaining indemnity limits) insures only GEGCO. Andromeda, which also insures only GEGCO, has \$50 million in limits available once Pole Star's limits are exhausted. Rock Solid insures both GEGCO and CPMG, and has available limits of \$25 million. Pole Star knows that its policy will be exhausted by any conceivable settlement figure, and is willing to tender its full remaining limits. Ultimately, therefore, the dispute is between the two excess carriers, and Andromeda wants Rock Solid to pay a full share of the settlement costs for CPMG as well as the largest possible share of GEGCO's contribution.

CHOICE OF LAW CONSIDERATIONS

In the absence of coverage litigation, the parties cannot identify with certainty which choice of law rules would apply in a dispute between Pole Star and Andromeda, on the one hand, and Rock Solid, on the other. The most commonly accepted rule governing choice of law analysis is that found in the Restatement (Second), Conflicts of Laws (1971). Specifically, Section 188 of the Restatement advises forum courts to employ the "most significant contacts" test when making the choice of law determination. Contacts considered by the courts when applying this test include the place of negotiation, execution and performance of the agreement, and the residency of the parties. In addition, Section 193 of the Restatement (Second) states that the location of the insured risk is of particular importance in cases involving liability insurance. The other commonly applied choice of law rule holds that the substantive law of the location of the place of contracting prevails (the *lex loci contractus* rule). Usually, this is determined by the last act that makes the contract valid and enforceable, in the insurance context usually delivery of the policy to the insured.

Here, application of the Restatement rule leads to an equivocal result. On the one hand, the insureds were both located in Illinois, which also was the place of negotiation, placement and delivery of the policies. The location of the insured risk, however, is in Virginia, which may outweigh the other factors which otherwise would point to the application of Illinois law to the coverage issues. A court applying the *lex loci contractus* rule, on the other hand, almost certainly would conclude that the contract was made in Illinois, thus requiring application of Illinois law. Accordingly, in attempting to fashion their positions, the insurers have to consider the law of both Illinois and Virginia.

"OTHER INSURANCE" CLAUSES

To assist with the allocation of payment obligations of insurers where more than one insurance policy applies to a loss, insurance policies routinely include "other insurance" provisions. A common type of provision, referred to as an "excess clause," affords coverage only "over and above" other insurance. North American Specialty Ins. Co. v. Liberty Mut. Ins. Co., 297 Ill. App. 3d 595, 598 (1998).

The Pole Star policy contains an "other insurance" provision that provides for a method of sharing with other primary policies, but CPMG's primary coverage has been exhausted. There is no question that Pole Star's remaining limit must go towards GEGCO's share of any settlement

without reference to the Rock Solid policy, since as between the Pole Star and Rock Solid policies, the Rock Solid's excess clause will apply.

What happens, however, when we compare the "other insurance" clauses of the Andromeda and Rock Solid policies? Both are identical, requiring each to be excess of the other. Plainly that is impossible. Under Illinois law, an "other insurance" clause providing "if other valid and collectible insurance with any other insurer is available to the insured . . . the insurance afforded by this policy shall be in excess of and shall not contribute with such other insurance," or words to that effect, is known as an "excess" clause. When two policies covering the same insured (here, GEGCO) for the same loss contain both excess clauses, "such provisions are to be disregarded as being mutually repugnant" Home Ins. Co. v. Underwriters at Lloyd's London, 729 F.2d 1132, 1135-36 (1984) (citations omitted).

According to Illinois courts, where "other insurance" provisions are disregarded because they are mutually repugnant, "[e]quity requires that both companies be on equal footing requiring an equal apportionment of the settlement which is within the limits of the respective policies." North American Specialty Ins. Co. v. Liberty Mutual Ins. Co., 297 Ill. App. 3d 595, 598, 697 N.E.2d 347 (1998) ("NAS"). Illinois law holds that "[t]wo insurers, both having mutually repugnant 'other insurance' clauses establishing 'excess' coverage, must divide the liability equally where neither policy specifies the method of apportionment." Id. Logically, since both insurers have equal obligations to their mutual insured, both must honor their policies and share coverage equally until the indemnity limit of the smaller policy is exhausted. Id. For this reason, since the Andromeda and Rock Solid policies do not specify a method of apportionment, under Illinois law they must equally divide liability for GEGCO's settlement share.

Under Virginia law the outcome is different. The Virginia Supreme Court has considered the question of an allocation of liability between two applicable insurance policies, where policy provisions are "virtually identical in effect, irreconcilable, and mutually repugnant." Aetna Cas. & Sur. Co. v. National Union Fire Ins. Co. of Pittsburgh, Pa., 233 Va. 49, 353 S.E.2d 894, 897 (1987). Relying on State Capital Ins. Co. v. Mutual Assurance Society, 241 S.E.2d 759 (Va. 1978), the court held that the irreconcilable provisions must be disregarded, and that a pro rata distribution is appropriate. 353 S.E.2d at 897. It is clear from both cases that "pro rata" means that each insurer pays at the same proportion as its limits bear to the total amount of available coverage. The Virginia Supreme Court noted, however, that this result is "particularly appropri-

ate” where the policies in question expressly provide for pro rata coverage in their “other insurance” clauses. Id.²

If the total settlement amount in our fact pattern is \$16 million, the first step is for the insurers to agree on an apportionment between GEGCO and CPMG, which for purposes of our coverage analysis we will assume is an even distribution of the total amount between the two policyholders. GEGCO’s and CPMG’s insurers therefore are responsible for \$8 million for each insured. Rock Solid is the only insurer for CPMG, so it will pay CPMG’s entire \$8 million share. As to GEGCO’s share, Pole Star has tendered its \$2 million remaining limit, since it stands first in line, thus reducing the disputed portion of GEGCO’s share to \$6 million. Since Rock Solid also insured GEGCO as an additional insured, it will argue for the application of Virginia law, under which it will pay one-third of that amount, or \$2 million (one-third being the ratio between its \$25 million limit and Andromeda’s \$50 million limit). Andromeda, of course, will argue for Illinois law, under which the two excess insurers will split the \$6 million *pro rata*, reducing Andromeda’s share from \$4 million to \$3 million. Large as this settlement might be, a \$1 million swing from one excess insurer to the other is certainly enough to give them an incentive to fight hard for their respective positions.

FACT PATTERN VARIANT

Let us change the facts so as to include, in the Andromeda policy, an endorsement that reads:

ENDORSEMENT #00001

It is hereby agreed that the [Andromeda] policy is amended to include the following condition:

There shall be no liability hereunder in respect of any claim which is insured by, or would, but for the existence of this Policy, be insured by any other existing policy, whether primary, excess or contingent.

All other terms and conditions of the policy remain unchanged.

² To illustrate that reasonable minds may differ on these sorts of policy questions, note that in the NAS case, NAS urged the fairness of using policy limits as the allocation method because Liberty received a greater premium for its policy. The Illinois court specifically rejected this argument. 297 Ill. App. 3d at 598.

Because it has the effect of voiding its own policy's coverage rather than making it excess of coverage provided by other valid and collectible insurance covering the same loss, these sorts of provisions are commonly known as "escape" clauses. If the Andromeda policy had an escape clause rather than an excess clause, under Illinois law it would be liable for the full amount of GEGCO's share. In the Home v. Lloyd's case, cited above, the court cited cases establishing that in Illinois, if co-insurers have different clauses, the excess clause prevails over the escape clause. That is, the insurer with the escape clause is primarily liable. 729 F.2d at 1135. Setting aside the tedious amount of discovery needed to determine whether the escape clause endorsement superseded the excess clause in the original policy, Andromeda would now be arguing for the application of Virginia law as giving it the better outcome, since Virginia courts have reasoned to a contrary result. In Government Employees Ins. Co. v. Universal Underwriters Ins. Co., 232 Va. 326, 350 S.E.2d 612, 615 (1985) the Virginia Supreme Court held that the very existence of excess coverage provided by a policy with an excess "other insurance" clause triggers the escape clause in another policy. As between the two policies, the policy with the excess clause becomes primary, and the policy with the escape clause has no liability at all. Thus, if it had an escape clause, the Andromeda policy if construed under Virginia law would pay nothing, and the Rock Solid excess policy would pay the entire \$6 million excess share of GEGCO's settlement contribution.³

EFFECT OF CONTRACTUAL INDEMNIFICATION CLAUSES

In Wal-Mart Stores, Inc. v. RLI Ins. Co., 292 F.3d 583 (8th Cir. 2003), the Eighth Circuit, applying Arkansas law in a diversity case, decided that an indemnification provision in the contract between two companies should act as the first line of "coverage" for an indemnitee, notwithstanding any other insurance coverage that the indemnitee might independently possess. Wal-Mart had a contract with a lamp supplier, Cheyenne, which included a broad indemnity agreement in favor of Wal-Mart. Cheyenne promised to indemnify Wal-Mart for any liability or loss resulting from Wal-Mart's sale of Cheyenne's lamps. RLI, Cheyenne's insurer, provided liability insurance coverage that included the contractual indemnity obligation. In these circumstances, the Wal-Mart court held:

Wal-Mart has an equitable argument in its favor. Wal-Mart's purpose in obtaining a promise from Cheyenne to indemnify it was to avoid liability for any claims arising out of its retail sales of Cheyenne's halogen lamps. The District Court en-

³ Note, however, that in Virginia use of an escape clause to avoid a duty to defend is void as against public policy. See State Farm Fire & Cas. Co. v. Scott, 236 Va. 116, 372 S.E.2d 383, 387 (1988).

tered an order making Wal-Mart jointly and severally liable to RLI for \$10 million for a loss that arose out of Wal-Mart's sale of Cheyenne's merchandise. It is exactly to avoid liability for suits like that brought by the [underlying] plaintiffs that Wal-Mart negotiated the indemnification provision with Cheyenne. We think that Wal-Mart deserves the benefit of its contractual bargain with Cheyenne, that is, not to be liable for claims stemming from its sales of Cheyenne's lamps.

292 F. 3d at 693.

The Eighth Circuit also based its conclusion on the fact that requiring Wal-Mart or its insurer to pay for this loss would be "incorrect because it would produce circuitous litigation" that would still result in RLI, Cheyenne's insurer, being ultimately liable for the \$10 million. The court explained:

This could occur in two ways, depending on whether Wal-Mart or National Union [Wal-Mart's insurer] satisfied the judgment for which the District Court made them jointly liable. If Wal-Mart paid the judgment, it would sue Cheyenne to enforce the indemnity provisions in their vendor agreement. As discussed above, Wal-Mart would win this suit and obtain a judgment against Cheyenne. Cheyenne would then look to its insurer, RLI, to cover this loss because the policy covers contractual indemnity liability. The end result would be that RLI would have to pay out \$10 million. A similar course of events would occur if National Union satisfied the judgment, except that it would step into Wal-Mart's shoes and bring a subrogation action against Cheyenne asserting Wal-Mart's contractual right to indemnification.

292 F.3d at 593-94.

Thus, if CPMG had promised in its contract with GEGCO to indemnify GEGCO for all liabilities of GEGCO arising out of CPMG's operation or maintenance of the pipeline, under the Wal-Mart line of authority (which has been recognized in Virginia, see St. Paul Fire & Marine Ins. Co. v. American International Specialty Lines Ins. Co., 365 F.3d 263 (4th Cir. 2004)), the indemnity provision would foreclose consideration of the "other insurance" clauses altogether and Rock Solid would pay for the entire settlement – and be obliged to reimburse Pole Star for its \$2 million contribution to the earlier settlement.

Here, however, the indemnifications are mutual, although they differ somewhat in the degree of fault needed in order to trigger the clauses.

In such an instance, it might require litigation of the underlying matter to determine the relative degrees of fault of the contracting parties. If both are at fault and both are required to indemnify the other, we are back to the circular litigation that the Wal-Mart court sought to avoid, and logically the test for allocating the loss would revert to consideration of the “other insurance” clauses described above.

CONCLUSION

In retrospect this analysis reads more like an argument for careful and cogent consideration of choice of law principles. But the laws of the two states dealt with in our analysis highlight the varying results that can drastically change the relative priority of coverage when multiple policies cover the same policyholder for the same loss. Taken to its logical extreme, the party that first determines which state’s law is of greatest benefit to it would have a potentially large incentive to bring a declaratory judgment action in a forum state where the choice of law rule would favor application of its preferred body of substantive law. The answer to the question, “who’s on first?” may well be determined by which party first evaluates its position accurately, and is first in line at the courthouse filing a lawsuit where the choice of law outcome is likely to be favorable.