

Civil Litigation Flash Points sm June 2007

Gina Di Bella, *Freeborn & Peters LLP*

Chicago | 312.360.6346 | freebornpeters.com | gdibella@freebornpeters.com

Competing Rules in Illinois: Horizontal v. Vertical Exhaustion

The Targeted Tender Doctrine

In Illinois, an insured who is insured under multiple policies may select which insurer will defend and indemnify it with respect to a specific claim. One of the most obvious reasons for an insured to select a particular insurer for its defense and indemnification is the insured's fear that its principal insurer will cancel the policy in the future or increase its premiums if that policy is invoked. *Cincinnati Cos. v. West Am. Ins. Co.*, 183 Ill.2d 317, 326, 701 N.E.2d 499, 503 (1998).

But Illinois courts have pushed this concept to the limit. Normally, the doctrine of equitable contribution would "permit[] one who has paid the entire loss to be reimbursed from other insurers who are also liable for the loss." *Inst. of London Underwriters*, 599 N.E.2d at 1313 (internal citations omitted). However, many Illinois courts have determined that an insured can entirely prevent an insurer from receiving contribution from other insurance policies covering the same loss simply by designating one insurer to respond to the loss and directing the other insurers not to become involved. *See, e.g., Inst. of London Underwriters v. Hartford Fire Ins. Co.*, 234 Ill. App. 3d 70, 599 N.E.2d 1311 (1st Dist. 1992), rev'd on other grounds by *Cincinnati Cos. v. West Am. Ins. Co.*, 183 Ill.2d 317, 701 N.E.2d 499 (1998). When an insured directs another insurer not to involve itself in the litigation, the insurer is then "relieved of its obligation to the insured with regard to that claim." *Cincinnati Cos.*, 701 N.E.2d at 503. This is referred to as the "targeted tender" or "selective tender" doctrine in Illinois. And Illinois courts have noted that an insured's right to choose which insurer will defend and indemnify it with respect to a specific claim is a "paramount" right. *Kajima Constr. Servs., Inc., v. St. Paul Fire & Marine Ins. Co.*, 368 Ill. App. 3d 665, 669, 856 N.E.2d 452, 456 (1st Dist. 2006) (citing *Legion Ins. Co v. Empire Fire & Marine Ins. Co.*, 354 Ill.App.3d 699, 822 N.E.2d 1 (1st Dist. 2004)).

Horizontal Exhaustion v. Vertical Exhaustion

Horizontal exhaustion, on the other hand, is a principle of Illinois law that "requires the insured to exhaust all primary policy limits before invoking excess coverage." *Kajima*, 856 N.E.2d at 456 (citing *Ill. Emcasco Ins. Co v. Continental Cas. Co.*, 139 Ill.App.3d 130, 487 N.E.2d 110 (1st Dist. 1985)).

The vertical exhaustion theory is the exact opposite. Vertical exhaustion "allows an insured to seek coverage from an excess insurer as long as the insurance policies immediately beneath that excess policy . . . have been exhausted, regardless of whether other primary insurance may apply." *Kajima*, 856 N.E.2d at 457 (internal citations omitted).

Which Rule Prevails in Light of the Targeted Tender Doctrine?

The horizontal exhaustion theory is at complete odds with the targeted tender doctrine. How can a court apply the horizontal exhaustion principle in light of the targeted tender doctrine? Does one rule supersede the other?

The *Kajima* case answers the very complicated question of whether the targeted tender rule supersedes the principle of horizontal exhaustion. *Id.* at 456. According to the Appellate Court of Illinois, First District, the answer is no. *Id.* This holding will have a major effect on many insurance companies and insureds who are covered by multiple policies for the same claim. Because of the fundamental importance of this holding, I explain the *Kajima* case in detail below.

Kajima Construction Services is a general contractor that was insured by Tokio Marine & Fire Insurance Company for a building project. *Id.* at 454. Kajima's subcontractor, Midwestern Steel Fabricators, Inc., obtained a commercial general liability ("CGL") insurance policy from St. Paul Fire & Marine Insurance Company for the building project that provided \$2 million of primary coverage and \$5 million in excess coverage. *Id.* at 454-55. Kajima was named as an additional insured on Midwestern's CGL policy. *Id.* During the building project, one of Midwestern's employees, Thomas Jones, was seriously injured. *Id.* at 455. Mr. Jones filed a personal injury action against Kajima and Midwestern alleging that his injuries were caused by their negligence. *Id.* Kajima made a "targeted tender" to Midwestern and St. Paul and notified them that it expected St. Paul to defend and indemnify it in the Jones case. *Id.* The Jones case settled during trial for \$3 million. *Id.* St. Paul paid its primary policy limit of \$2 million and Tokio contributed its primary limit of \$1 million to satisfy the settlement. *Id.*

Kajima and Tokio (collectively "Tokio") then filed a declaratory judgment action against St. Paul seeking reimbursement for Tokio's contribution to the settlement. *Id.* Tokio argued that it was not responsible for Kajima's defense or indemnification because Kajima made a "targeted tender" to St. Paul. *Id.* Therefore, Tokio argued that "St. Paul alone must respond to the defense and indemnity with both its primary and excess coverage policy limits before Tokio's primary limits are invoked." *Id.* St. Paul, on the other hand, argued that although Kajima has the right to selectively tender its defense and indemnification to one of several insurers, the horizontal exhaustion principle in Illinois requires that all primary policies be exhausted prior to reaching any excess policy. *Id.*

This is the first time any Illinois court has decided whether an insured can selectively tender its defense and indemnification to an insurer and require that insurer to reach into its excess layer if the claim exceeds the primary limit before any other insurance policy is invoked. The First District thoroughly analyzed the horizontal exhaustion principle in light of the targeted tender doctrine. The court agreed with St. Paul's argument that Tokio's application of the targeted tender rule would "run afoul of well-established principles of Illinois insurance law recognizing differences between primary and excess coverage." *Id.* at 458. The court agreed that Kajima's application of the targeted tender rule would be an application of vertical exhaustion rather than horizontal exhaustion, "which would be tantamount to ignoring distinctions that this court has previously recognized between primary and excess insurance." *Id.* The court noted that an excess policy "is unique in that it always remains excess over and above other contracts . . . and thus [cannot] be activated until all primary coverage is exhausted. *Id.* (citing *Ill. Emcasco Ins. Co. v. Continental Cas. Co.*, 139 Ill. App. 3d 130, 487 N.E.2d 110 (1st Dist.1985) (emphasis added)). Therefore, the Kajima court held that an excess policy may never be activated through a targeted tender prior to exhausting the insured's other primary coverage first. *Kajima*, 856 N.E.2d at 458.

Tokio appealed the First District's ruling and the Supreme Court of Illinois allowed the appeal on January 24, 2007. *Kajima Const. Servs., Inc. v. St. Paul Fire & Marine Ins. Co.*, 862 N.E.2d 234 (Ill. 2007). The Supreme Court of Illinois has not issued its ruling yet. Until it does, all insurance companies and insureds covered under multiple policies should be aware of the First District Kajima holding. As a result of this case, an insured will be forced to exhaust its primary policy limits before it can invoke excess coverage, regardless of whether it "selectively tenders" its defense and indemnification to a particular insurer and regardless of whether it demands that another insurer not involve itself in the litigation.