

April 1, 2007

RE: Defining the Breadth of Selective Tenders of Defense

A recent First District Appellate Court decision, North River Ins. Co. v. Grinnell Mutual Reinsurance, 369 Ill.App.3d 563, 860 N.E.2d 460 (1st Dist. 2006), addressed for the first time the application of the selective tenders of defense to excess insurers. The North River court affirmed the trial court and held that the selective tender rule also applied to excess coverage. It also held that an insured is not entitled to vertically exhaust consecutive primary and excess policies. Instead, all primary coverage must be exhausted prior to reaching the limits of any excess policies.

The general contractor in North River, Kajima Construction entered into a subcontract with Shelco Steel Workers to perform construction work on a project. Shelco then subcontracted its obligation to Kajima to American Miscellaneous Steel. During the project, an employee of American, Farkas, was injured when an iron bar joist fell on him while he was working. Farkas filed suit against Kajima, Shelco and others.

Shelco was an insured under a CGL policy issued by North River and an excess umbrella policy issued by U.S. Fire. American was an insured under a CGL policy and an umbrella policy issued by Grinnell Mutual. Kajima was a named insured under a CGL and an excess policy, which were issued by Tokio Marine and Fire Insurance Company. Each of the primary policies had limits of \$1 million and each of the umbrella policies had limits in excess of \$2 million.

Upon receiving notice of the Farkas suit, Kajima tendered its defense to North River and Grinnell. The tender indicated that Kajima was seeking an exclusive defense and indemnity from the insurers of Shelco and American. Kajima de-selected Tokio from responding to the suit. North River and Grinnell accepted Kajima's tender and shared costs of its defense.

During the pendency of the suit, it became apparent that it was not possible to settle within the policy limits of the North River and Grinnell policies. Accordingly, North River sought \$500,000 toward the settlement from Tokio, however Tokio refused to contribute. Ultimately, the Farkas suit was settled for \$4 million, which was comprised of \$1 million each from North River and Grinnell and \$2 million from the U.S. Fire excess umbrella policy. Thereafter, U.S. Fire, Shelco, and North River sought declaratory relief against Grinnell and Tokio. The declaratory action sought, *inter alia*, a determination that Tokio was required to exhaust its primary CGL policy before the limits of the U.S. Fire umbrella policy were reached.

Tokio argued that it was not obligated to contribute to Kajima's defense and indemnity because Kajima had selectively tendered the suit to Shelco, American, and their respective insurers. U.S. Fire argued that the selective tender rule did not apply to excess coverage layers. Grinnell ultimately settled with U.S. Fire by paying \$500,000 from its excess policy to reimburse U.S. Fire.

The circuit court granted summary judgment in favor of U.S. Fire and against Tokio relative to Tokio's claim that the horizontal exhaustion doctrine preempted the selective tender rule. It ruled that the selective tender rule applied to excess policies and the excess policies were not available for indemnity until the targeted primary insurers had exhausted their limits. The circuit court reiterated that the horizontal exhaustion doctrine still applies under Illinois law, but it does not preempt the selective tender rule.

Horizontal exhaustion requires an insured that has multiple primary and excess policies covering a common risk to exhaust all primary coverage before invoking excess coverage. Conversely, vertical exhaustion allows an insured to seek coverage from an excess policy, even if other primary insurance may apply, as long as the insurance policies immediately beneath that particular excess policy have been exhausted

Tokio appealed the grant of summary judgment by the circuit court and U.S. Fire cross-appealed. Tokio's contended on appeal that vertical exhaustion of Shelco's primary and excess policies was proper because Tokio's policy was not "triggered", pursuant to the selective tender rule.

The appellate court cited Kajima Construction Services, Inc. v. St. Paul Fire and Marine Ins. Co., 368 Ill.App.3d 665, 856 N.E.2d 452 (1st Dist. 2006), for the proposition that the selective tender rule does not entitle an insured to vertically exhaust consecutive insurance policies, and de-selected primary insurers must respond before an excess policy will become activated. Based upon this precedent, the appellate court held that the circuit court correctly ruled that the selective tender rule did not preempt the horizontal exhaustion doctrine, and vertical exhaustion was inappropriate. Hence, Tokio was required to contribute its primary policy toward the settlement before any excess coverage could be activated. Moreover, the appellate court held that an insured may selectively tender its indemnity to concurrent excess insurers, once all concurrent primary coverage has been exhausted.

The North River decision not only reaffirms the established principle that an insured's right to selectively tender is paramount, but establishes that this right extends to the selection of excess policies. This maintains the critical distinction between primary and excess policies, and further defines an insured's rights relative to selecting insurers to respond to a suit. Previously, it was an open question whether an insurer that had been de-selected by an insured from responding to a suit could effectively close its file and not be required to respond under any circumstances. The North River court makes it clear that an insurer who has been de-selected from a suit may want to keep tabs on the suit, especially if there is the potential for the suit to exhaust the limits of the other primary insurance coverage.

If you have any questions, please contact Bill or myself.

Very truly yours

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