

Excess Insurance—Rights and Obligations

By Patrick J. Boley

Excess insurance is playing an increasingly prominent role in the resolution of liability claims. The continued growth of jury verdicts, the rise of mass torts, the development of intricate, layered, corporate liability insurance programs, and the marketing of personal umbrella policies are among a variety of factors pushing excess liability insurance to the fore.

Determining coverage of claims under excess insurance policies can take on levels of complexity beyond that seen with claims involving primary insurance policies. Ascertaining the rights and obligations attending an excess insurance policy may involve—among many other things—reconciling the excess form with the underlying coverage, interpreting a jurisdiction’s exhaustion of coverage rules, dealing with the implications of insolvent insurers, and determining, if applicable, the excess insurer’s role in the defense and settlement of the claim. Parties on all sides of a coverage dispute need to understand these issues. An excess insurer will not be excused for failing to honor its obligations just because the issues are complicated.

It would be impossible to enumerate here all the factors that shape the rights and obligations arising from excess insurance policies. However, this article will provide some important guideposts. As always, the language of a policy is the starting point. We then will consider exhaustion: specifically, under what circumstances can we deem primary insurance coverage exhausted? This is usually the necessary precondition for an excess insurer’s indemnity obligations. As part of this discussion, we also will consider how other insurers’ insolvencies affect an excess insurer’s obligations. Finally, we will review the basic rights and obligations involved in the defense and settlement of claims and the interaction between primary and excess insurers.

The Importance of Policy Language

It is important to consider at the outset what we mean by “excess” coverage. An excess insurer does not usually assume liability under an excess policy until a predetermined amount of underlying coverage has been exhausted. William P. Shelley, Richard C. Mason & Nancy C. Thome, *Fundamentals of Insurance Coverage Allocation*, 14-9 Mealey’s Litig. Rep. Ins. 13 (2000). Variations in excess policy coverage make it critical to know the specific policy terms at issue, as well as those of other policies implicated by a claim, to understand how an excess policy applies to a given coverage dispute.

Excess policies typically fall into one of two categories: (1) “follow form” policies, which generally provide the same terms, conditions, and policy period contained in a designated underlying or “primary” policy; or (2) “umbrella” policies, which often provide broader coverage than the underlying, primary policy, and which may require the umbrella policy to “drop down” to assume coverage under terms similar to a primary policy’s, including a duty to defend, in situations in which the primary policy does not apply. *Id.*

Among these categories, there is a lot of variety. Some excess insurance policies do not follow form, but contain their own terms and conditions. Some excess insurance policies that purport to follow form may contain terms that attempt to remove the defense obligation altogether, or convert it to a duty to reimburse the policyholder for incurred defense costs. Similarly, while some excess insurance policies contain drop-down provisions, others do not. “Other insurance” provisions, which may affect an insurer’s contribution rights against other insurers, vary from policy to policy.

These and numerous other variations make it critical to know the specific policy terms at issue, as well as those of other policies implicated by a claim, to understand how an excess policy applies to a given coverage dispute. In some instances, the underwriting intent between an insured and the primary insurer may also affect the excess insurer's obligations. *See, e.g., Great Atlantic Ins. Co. v. Liberty Mut. Ins. Co.*, 773 F.2d 976 (8th Cir. 1985) (finding in a case involving a retroactive agreement between an insured and a primary insurer that only one of the primary's policies applied to losses in the United States was binding on the excess insurer).

Exhaustion Requirements and Methodologies

Many of the rights and obligations of excess insurers are premised on the requirements and methodologies that determine exhaustion of the coverage limits or retentions in underlying policies. These issues relate to the basic question, when must an excess policy insurer respond to a claim? Specifically, must the policyholder's underlying coverage have been exhausted due to actual payment of the policy limit amount, or can the policyholder settle for less than the primary policy's coverage limit, absorb the gap between the settlement and the primary coverage limit, and then seek coverage from the excess insurer? The relevant methodology for a claim or set of claims may not only depend on the policy language and the law of a particular jurisdiction, but also on whether the underlying facts implicate more than one policy period.

A substantial majority of courts have held that payment of a primary coverage limit is not a prerequisite for a policyholder to obtain coverage from its excess insurer when a claim implicates a single year of coverage. These courts often cite the Second Circuit's analysis in *Zeig v. Massachusetts Bonding & Insurance Co.*, 23 F.2d 665 (2d Cir. 1928) (*Zeig*), which held that a policyholder can settle with the primary insurer, absorb the difference between the

settlement and the primary policy limit, and seek coverage from the excess insurer for the amount in excess of the primary policy limit.

The *Zeig* court reasoned that the excess insurer “had no rational interest in whether the insured collected the full amount of the primary policies, so long as it was only called to pay such portion of the loss as was in excess of the limits of those policies.” *Id.* at 266. The court also emphasized that a contrary ruling would increase delay, promote litigation, and prevent settlement of disputes. *Id.*

In contrast, the recent decisions in *Comerica, Inc., v. Zurich American Insurance Co.*, 498 F. Supp. 2d 1019 (E.D. Mich. 2007), and *Qualcomm, Inc., v. Certain Underwriters at Lloyd’s*, 161 Cal. App. 4th 184 (Cal. Ct. App. 2008), departed from the *Zeig* rule. In both cases, the courts held that the exhaustion requirements of the excess policies precluded the policyholders from settling with their primary insurers for less than limits before seeking coverage from the excess insurers.

The contrasting analyses in these decisions require an excess insurer to carefully consider its exhaustion arguments before refusing to settle an excess claim. Among other things, this evaluation includes considering: the language of the excess policies, the controlling law of the applicable jurisdiction, whether courts in the jurisdiction have expressed a policy in favor of settlements, the specific interest that the excess insurer has in forcing full payment of an underlying policy limit, and the excess insurer’s potential liability for bad faith. *See generally* Patrick J. Boley, *Penny Wise and Pound Foolish? Issues for Excess Insurers in the Wake of Comerica and Qualcomm*, Covered Events, Aug. 2009.

In more complicated situations, when the facts implicate more than one policy period, the parties may need to consider whether horizontal or vertical exhaustion rules apply. Horizontal

exhaustion generally requires that an insured exhaust the entire layer of applicable primary policies before seeking excess coverage. *See, e.g., Missouri Pacific R.R. Co. v. Int'l Ins. Co.*, 679 N.E.2d 801, 810 (Ill. App. 1997). With vertical exhaustion, an excess insurer's liability begins when the primary insurance for the policy year covered by the excess policy is exhausted—even if primary policies for other periods may not have been exhausted. *See, e.g., Koppers Company, Inc. v. Aetna Cas. & Sur. Co.*, 98 F.3d 1440, 1454 (3rd Cir. 1996).

The impact of a court's decision to apply vertical, as opposed to horizontal, exhaustion can be easily seen through a simple example. Consider a policyholder found liable to pay \$10 million to remediate a polluted site. The policyholder's involvement with the site under the applicable methodology activating coverage indicates that 10 years of coverage is warranted. Assume that the policyholder had 10, one-year, primary liability policies during this period, each with a \$1 million limit, and only one excess policy in year two for \$10 million.

The financial implication of the exhaustion method for the excess insurer could be substantial. In a jurisdiction in which horizontal exhaustion is required, the excess insurer in this scenario would not have to pay anything. The excess insurer could also raise questions about whether the policyholder has included all relevant policy periods within its calculation of horizontal exhaustion. This raises the possibility of disputes over the appropriate trigger period, beyond the more basic question of whether the excess insurer's policy year has been triggered, and whether insurance coverage was available for the liabilities at issue. In contrast, in a jurisdiction permitting vertical exhaustion, the policyholder could choose to allocate all of its liability to year two, with the result that the excess insurer would bear liability for \$9 million.

It is worth noting that the policyholder in this scenario might well have strategic reasons for singling out the excess insurer. Doing so might help the policyholder to avoid self-insured

retentions, insolvent policies, or non-covered years. It would also help to preserve potentially unlimited defense obligations contained in the policyholder's primary policies.

Of course, the excess insurer might later seek contribution from the other primary insurers, assuming that the jurisdiction permits contribution. *See J.H. France*, 626 A.2d at 509. At least initially, however, both the liability and the risk of non-recovery would largely shift to the excess insurer.

Again, it is important to carefully assess the rules of a given jurisdiction to determine exactly how they may apply. For example, a horizontal exhaustion rule might seem to follow from a pro rata by time-on-the-risk allocation methodology. A strong argument can be made, however, that if a pro rata allocation is applied to an injury-in-fact trigger, there is no need for horizontal exhaustion; the trigger calculation method already contemplates the appropriate assignment of damages to each policy period.

It is also important to consider the interaction of basic exhaustion rules, such as those in *Zeig* or *Qualcomm*, with the trigger and allocation rules of a jurisdiction. In allocating claims over multiple policy periods, courts often expressly ignore "other insurance" clauses and similar provisions, reasoning that allocation is based on equitable principles. *See, e.g., Outboard Marine Ins. Corp. v. Liberty Mut. Ins. Co.*, 670 N.E.2d 740, 750 (Ill. Ct. App. 1996). Courts in this context may be reticent to strictly apply exhaustion clauses—particularly if doing so would limit the possibility of settlements and force a trial on all coverage issues in a complex dispute.

The Effect of Underlying Insolvencies

Regardless of the exhaustion method, policyholders and insurers may have to confront the issue of whether an insurer's insolvency constitutes exhaustion of a policy coverage limit. Courts

have varied in their resolution of this issue, many basing their decisions on the specific language in an excess policy, others on equitable factors.

For example, in California, whether a primary insurer's insolvency requires the excess insurer to drop down to assume coverage responsibility may depend on the policy's language. In *Reserve Insurance Co. v. Piscotta*, 30 Cal. 3d 800, 814–15 (Cal. 1982), the excess policy provided coverage for “any excess over the ‘amount recoverable’ under the underlying policy.” To the California Supreme Court, this created an ambiguity because the “amount recoverable” from the insolvent primary insurer was substantially less than the primary policy limit. *Id.* Accordingly, the court determined that the excess carrier was obligated to drop down to assume coverage. *Id.*

In contrast, in *Denny's, Inc., v. Chicago Insurance Co.*, 234 Cal. App. 3d 1786 (Cal. Ct. App. 1991), the excess policies provided that liability would begin when the underlying insurer had paid or had been held liable to pay the amount of the underlying insurance. The court interpreted this language to require the excess insurer to begin to pay once the insured's liability exceeded the amount of the underlying insurance, whether or not the primary insurer had actually paid the policy limit. *Id.* at 1793–94.

In *Kaiser Aluminum & Chemical Corp. v. Certain Underwriters at Lloyds, London*, 2003 Extra LEXIS 174 (Cal. Dep't Super Ct. 2003), the California Superior Court in San Francisco County addressed the question of whether a policyholder could move outside a vertical line of underlying insurance to tap into a horizontal policy to fill gaps created by an insolvent insurer. The court held that it could. Through such “hopscotch,” the policyholder was able reach the solvent insurer sitting above the insolvent insurer's policy.

Another interesting issue addressed by the court in *Kaiser* was how the court should allocate coverage when certain insurers participating in an excess coverage block had become insolvent: “If one participant in a block becomes insolvent, the question is raised as to whether the other insurers have to fill the gap in their block (up to policy limits).” *Id.* at *20. The answer depended on the policy form.

Two forms were at issue. One stated the excess insurer’s liability in the declarations as a dollar amount portion of the dollar amount total of the block: for example, “3,000,000 part of \$10,000,000.” *Id.* at *20. The second form expressed the proportion in terms of percentages: for example, “8 % pro rata participation in the layer \$25,000,000 excess of \$50,000,000 & primary.” *Id.*

With respect to the first form, the court held that a participating insurer could allocate up to its individual limit without a proportionate share of liability allocated to other insurers participating in the quota share: “Thus, an insurer which is obligated for \$3,000,000 of \$10,000,000” is obligated for a maximum of \$3,000,000, with no expressed limitation as to a proportionate reduction should part of the remaining \$7,000,000 fail to be available.” *Id.* at * 22.

The result under the second form was different. The *Kaiser* court explained:

These policies specifically state that the insurer is responsible for a fixed percentage pro rata participation in a defined layer. . . . Each is defined in reference to the other participants by virtue of the pro rata percentage language. Thus, each insurer with this liability language must participate to its percentage level as stated in the policy, whether or not such percentage participation also exhausts the maximum dollar participation of such insurer in the block.

Id. at **22–23.

Rights and Obligations in Responding to Claims

Depending on the exhaustion language or rules applicable to a particular claim, an excess insurer may not have an obligation to act on a claim as long as it appears that the policyholder's potential liability will not require coverage from the excess policy. *See Keck Mahin & Cate v. Nat'l Union Fire Ins. Co.*, 20 S.W.3d 692 (Tex. 2000). Even in this situation, however, the excess insurer may still be well advised to monitor the claim. *See Assoc. Wholesaler Grocers, Inc. v. Americold Corp.*, 934 P.2d 65, 91 (Kan. 1997) (“[T]he excess carrier may have to decide coverage instantaneously when settlement is demanded. The noninvestigating carrier may be unprepared.”). But it should proceed in a way that avoids interfering with the settlement of the claim against the insured or with the primary insurer's handling of the insured's claim for coverage. If a court finds that an excess insurer improperly interfered, it may be held liable for bad faith. *Compare Felman Production, Inc., v. Industrial Risk Insurers*, 2009 WL 3380345 (S.D. W.V. 2009) (reinsurer inserted itself into claims process and thus denied dismissal of bad faith claim); *Admiral Ins. Co. v. Columbia Cas. Ins. Co.*, 486 N.W.2d 351 (Mich. Ct. App. 1991) (excess insurer not liable). Once it appears that a loss may exceed the primary insurance limits, an excess insurer's obligations change.

- **The Duty to Defend**

Whether the primary or the excess insurer controls the defense of an underlying claim is a function of the language of the policies, and, if the excess insurance policy includes the right to assume control, the decision of the excess insurer to exercise that right. Many excess insurance policies include a right to associate in the defense, but absent policy language to the contrary, the excess insurer generally has no duty to participate in the defense until the primary insurance limits are exhausted. *See Diamond Heights Homeowners Ass'n v. Nat'l American Ins. Co.*, 227

Cal. App. 3d 563, 577 (Cal. Ct. App. 1991). Certain primary policies may allow the primary insurer to tender its limits in settlement, relieving it of any further duty to defend. *See, e.g., Woodson v. Kreutzer*, 526 N.W.2d 788, 791 (Wis. Ct. App. 1994). Other primary policies—particularly those written on older forms—require the primary insurer to continue defending even if the potential liability exceeds its limits, and the primary insurer may not relieve itself of the duty to defend. *See Diamond Heights*, 227 Cal. App. 3d at 577; *Gross v. Lloyds of London Ins. Co.*, 358 N.W.2d 266, 269–70 (Wis. 1984) (explaining the development of ISO forms).

As noted above, excess insurance policies vary regarding whether an excess insurer has a drop-down duty to defend, an obligation to reimburse for defense costs, or no obligation at all.

An excess insurer's obligation to participate in a defense is also sometimes the function of a jurisdiction's law on the subject. This is not to suggest that a court can make an excess insurer with no defense obligation pay defense costs. But if an excess insurance policy includes a defense obligation and the claim exceeds the limits of the available primary insurance coverage, some courts have held that an excess insurer must contribute to the defense. *See Ostrager & Newman, Insurance Coverage Disputes*, § 6.03[c] (2008) (and cases cited therein). Such an approach becomes more compelling as the amount of the claim against the insured increases. *See, e.g., Schulman Inv. Co. v. Olin Corp.*, 514 F. Supp. 572, 577 (S.D.N.Y. 1981).

Even in situations in which the primary insurer must initially defend a claim in its entirety, that duty may not remain static. Some jurisdictions permit a primary insurer to settle a claim for its policy limit amount, and for any amount above that limit, obtain a full release from the policyholder, and leave the excess insurer to defend the claim against its limits. *See, e.g., Teigen v. Jelco of Wisconsin, Inc.*, 367 N.W.2d 806, 809 (Wis. 1985). In *Teigen*, the excess insurer objected to this strategy. The Wisconsin Supreme Court, however, observed that the

settlement indirectly benefited the excess insurer by immunizing it from liability for a judgment in excess of limits. *Id.* at 811.

- **Participation in Settlement Discussions**

Courts differ on the point at which an excess insurer must become involved in settlement. Many courts hold that an excess insurer has a duty to accept a reasonable settlement, but this duty is not typically invoked until the primary insurer has tendered its limits. *See Keck Mahin & Cate*, 20 S.W.3d at 701 (and authorities cited therein).

Others have applied a different analysis. For example, in *Rummel v. Lexington Insurance Co.*, 945 P.2d 970, 984 (N.M. 1997), the New Mexico Supreme Court stated that, even without a duty to assume charge of settlement, an excess insurer might still bear liability for bad faith if it refuses to participate in or at least monitor the progress of the settlement negotiations. The excess insurer may also be held to have abdicated any right to object to the final settlement:

This is because the insurer's refusal to discuss the settlement of a claim for which it may be liable can influence the final outcome of settlement negotiations. Without the participation of a potential crucial party, the participants to the settlement may be unable to accurately assess the extent of the insured's coverage. The insured may risk greater exposure to personal liability.

Id.

A different problem arises when an excess insurer is locked out of the settlement process. An excess insurer's rights in this situation may well depend on its own posture prior to settlement. If the excess insurer previously denied coverage, it may have waived its rights to complain. *See United Services Auto. Ass'n v. Alaska Ins. Co.*, 94 Cal. App. 4th 638, 644 (Cal. Ct. App. 2001). If, on the other hand, the excess insurer simply reserved its rights and was thereafter deprived of a reasonable opportunity to respond to settlement demands or to participate in the settlement process, it may not be bound to the settlement reached by other

parties. *See Home Insurance Co. v. Tooke*, 496 N.W.2d 749, 750–52 (Wis. Ct. App. 1993). The excess insurer may also have a cause of action for bad faith against the primary insurer.

- **Bad Faith**

There can be little question that excess insurers can be held liable to their policyholders for bad faith on some of the same or similar theories that apply against primary insurers. *See, e.g., Associated Wholesale Grocers*, 934 P.2d at 90; *Rummel*, 945 P.2d at 984. The more interesting issues, however, involve the relationships between excess and primary insurers.

Courts differ on whether primary insurers owe a duty of good faith and fair dealing to excess insurers. Some courts reject the existence of a duty. *See, e.g., Loy v. Bunderson*, 320 N.W.2d 175 (Wis. 1982) (finding an excess insurer had no right to assert a bad faith claim against a primary insurer because no contract existed between the two insurers). Yet, even in these jurisdictions, courts may allow an excess insurer to assert a bad faith claim against a primary insurer under the principle of equitable subrogation and, as such, to assume the rights of the insured on its behalf. *See Teigen v. Jelco of Wisconsin, Inc.*, 367 N.W.2d 806 (Wis. 1985).

Other courts have found that the reasonable foreseeability that liability involved in a claim may reach an excess policy's limit creates a three-way duty of care on the part of the primary insurer to act reasonably and in good faith in settling meritorious claims within the policy limits. *See, e.g., Schal Bovis, Inc. v. Casualty Ins. Co.*, 732 N.E.2d 1082, 1090 (Ill. App. 1999); *Argonaut Ins. Co. v. Hartford Acc. & Indem. Co.*, 687 F. Supp. 911, 914 (S.D.N.Y. 1988) (recognizing fiduciary relationship).

This principle has been extended to relationships between underlying, primary and secondary, excess insurers, though the rule may not apply if the excess insurer lacked substantial

control of the litigation. *Compare Central Illinois Public Service Co. v. Agricultural Insurance Co.*, 880 N.E.2d 1172, 1178 (Ill. App. 2008) (CIPS) (imposing a duty of good faith on an underlying insurer), *with Liberty Mut. Ins. Co. v. American Home Assur. Co.*, 348 F. Supp. 2d 940 (N.D. Ill. 2004) (“Control over the defense of the litigation is an important factor in deciding whether to impose a duty.”).

In CIPS, the court observed that the excess insurer had a provision in its policy giving it the right to control the defense and settlement negotiations. This allowed the possibility that it could become liable to secondary excess insurers if it did not exercise that control in good faith.

Conclusion

Reconciling an excess insurance form with the underlying coverage, identifying and interpreting the appropriate exhaustion rules, assessing the fallout from insolvent insurers, and determining the excess insurer’s appropriate role in the defense and settlement of a claim—these are among the important steps that parties must take in determining the rights and obligations of an excess insurer for a claim.

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