

Excess Liability Insurance: Coverage Disputes and Possible Solutions

Introduction

As average D&O claims severity has increased and defense expense has escalated in recent years, excess D&O insurance participation has become an increasingly critical part of D&O claims resolution. Perhaps because of the growing claims involvement of excess D&O insurance, D&O coverage disputes involving excess insurers are increasingly common. This article reviews several recent court decisions that illustrate excess insurance coverage disputes examines the implications and possible solutions.

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Recent Excess Insurance Case Developments

Must a "follow form" excess insurer adopt the primary carrier's coverage position?: In an August 6, 2007 opinion, the Massachusetts Supreme Judicial Court addressed the question of "whether a follow form insurer is bound by the decision of a primary insurer to settle a claim." Although this particular case involved Insurance Company Professional Services Liability policies, the ramifications may spill into other liability policies.

The coverage dispute arose out of an underlying class action lawsuit against Allmerica alleging improper practices in the sale of life insurance. The underlying case ultimately settled. The total value of the underlying settlement plus litigation expense was \$39.4 million.

Allmerica's primary insurance policy's limit of liability was \$20 million, over a \$2.5 million self-insured retention. Allmerica's liability insurance program also included an additional \$10 million layer of follow form excess insurance over the primary policy. The excess policy's follow form language provided that, "this Policy is subject to the same conditions, limitations and other terms...as are contained in or may be added to the Polic(ies) of the Primary Insurer(s)."

Following the class action settlement, Allmerica and its primary insurer reached an agreement in which the primary insurer agreed to pay its full \$20 million policy limits. However, Allmerica's excess liability insurer "generally disclaimed

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coverage for any loss encompassed by the settlement," in reliance upon certain policy exclusions. Allmerica filed a declaratory judgment action against the excess insurer in Massachusetts state court.

On consideration of cross-motions for summary judgment, the trial court ruled that the excess carrier was not bound by the primary carrier's actual or implied coverage determination, and also ruled that certain exclusions and coverage defenses precluded coverage under the excess policy. The trial court judge granted summary judgment in favor of the excess insurer, and Allmerica appealed.

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The appeals court agreed with the trial court's ruling that the follow form excess insurer was not bound by the primary carrier's decision to provide coverage, but the appeals court also found that disputed issues of material fact remained with respect to the excess insurer's coverage defenses, and so remanded the case back to the trial court for further proceedings.

In ruling that the excess carrier was not bound by the primary carrier's coverage determination, notwithstanding the excess policy's follow form language, the appeals court emphasized that the two policies are "separate and distinct contracts," in which each insurer had agreed "individually to cover a particular portion of risk." The follow form language "allows an insured to have coverage for the same set of potential losses" but the follow form language "does not...bind the various insurers to a form of joint liability." The "layer of risk" each insurer covers is "defined and distinct." The appeals court specifically noted that "primary and excess insurers act independently of each other with respect to decisions about their policies including coverage determinations and settlements."

With respect to the excess carrier's follow form language, the appeals court also said:

An excess carrier's intent to incorporate the same words used in a separate agreement between the primary insurer and the insured does not imply an intent by the excess carrier to accept decisions made by the primary carrier about the extent of obligations under its own agreement. By adopting the form of words used by [the primary carrier], [the excess carrier] did not also cede to it the right to make decisions about the [excess carrier's] obligation to perform in certain circumstances. To conclude otherwise would undermine the distinct and separate nature of each insurer's contract with Allmerica.

Is an excess policy triggered if the primary policy pays less than its full limit of liability and the policyholder funds the resulting gap? Two recent court decisions, one in July 2007 involving Comerica and the other in March 2008 involving Qualcomm, addressed the question whether an excess policy is triggered when a compromise between the policyholder and the primary insurer creates a "coverage gap" that is funded by the policyholder.

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Comerica Decision

The dispute between Comerica and its excess insurer arose in connection with securities class action lawsuits that were filed against Comerica and certain of its directors and officers. The class actions ultimately settled for \$21 million.

Comerica's primary D&O insurance policy had a \$20 million limit of liability, and Comerica also had an additional follow form \$10 million policy excess of the primary coverage. (Comerica had additional excess coverage beyond that, but the additional coverage is not relevant here.) By its terms, the excess policy recognized "depletion" or "exhaustion" of the underlying policy "solely as a result of payment" under the underlying policy. The excess policy also specifically noted that it did not provide coverage for any loss that is covered under the underlying policy but that is not paid by the underlying insurance.

Both before and after the underlying settlement, the primary carrier disputed coverage. The primary insurer contended that Comerica had violated the policy's cooperation and consent requirements. The primary insurer also argued that a portion of the underlying settlement was restitutionary in nature and therefore not covered under the primary policy. The primary insurer further contended that Comerica had made misrepresentations in the application process. Comerica and the primary insurer ultimately resolved their coverage dispute, with the primary insurer agreeing to pay \$14 million toward the \$21 million underlying settlement.

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Comerica then demanded that the excess insurer pay \$1 million toward the underlying settlement plus \$2.1 million in defense costs. The excess carrier refused to pay on the grounds that the primary policy had not been exhausted. Comerica filed a declaratory

judgment action against the excess carrier. Among other things, Comerica argued that allowing the excess insurer to disclaim coverage would violate public policy, and that the excess carrier's policy was ambiguous.

Comerica's public policy argument was based on the contention that Comerica's own payment of the \$6 million "gap" between the \$14 million compromise with the primary carrier and the \$20 million excess policy attachment point was the "functional equivalent of exhausting the primary policy." Comerica argued that to require exhaustion of the underlying policy, triggering payment obligations under the excess policy, would violate public policy by causing delay, promoting litigation, and preventing dispute adjustment.

The Court found that Comerica's excess policy unambiguously "requires that the primary insurance be exhausted or depleted by the actual payment of losses by the underlying insurer. Payments by the insured to fill the gap...are not the same as actual payment."

The Court added that Comerica could have sued the primary carrier and tried to establish that the primary carrier was obligated to pay its entire \$20 million limit, but instead Comerica compromised for a \$14 million payment, about which Judge Lawson noted:

Comerica seeks the certainty that its settlement [with the primary insurer] brought and the benefit of coverage from its excess carrier as if it had won its dispute with the primary insurer, despite language in the excess policy to the contrary. No public policy argument says that Comerica may have its cake and eat it too.

Finally, the Court said that to adopt the position that Comerica urged "would require a holding that parties simply cannot contract for an excess policy to be triggered only upon full, actual payment by the underlying insurer." He noted that Comerica could have, but did not, bargain for an excess policy that would pay for any liabilities over \$20 million, even if the underlying insurer did not pay the entire \$20 million — "the present agreement does not say that, and it cannot be rewritten now."

Qualcomm Decision

A March 25, 2008 California intermediate appellate court opinion held that, given the policy language involved, an excess D&O insurance policy was not triggered where the underlying insurer neither paid nor was obligated to pay its full policy limit of liability. For the policy period March 15, 1999 through March 15, 2000, Qualcomm had \$40

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million of D&O insurance, structured with a primary limit of \$20 million and an excess follow form layer of \$20 million above the primary \$20 million limit. During the policy period, Qualcomm employees and former employees brought lawsuits asserting rights to unvested company stock options. Qualcomm later settled these lawsuits and sought reimbursement from its D&O insurers for its defense expense and the settlement amounts.

The excess policy's exhaustion clause provided that the excess carrier "shall be liable only after the insurers under each of the Underlying policies have paid or have been held liable to pay the full amount of the Underlying Limit of Liability."

Qualcomm ultimately reached a compromise with its primary D&O insurer, whereby Qualcomm gave the primary insurer a full policy release in exchange for the primary carrier's payment of \$16 million. Even with this \$16 million payment, however, Qualcomm still had unreimbursed defense expense of \$3.6 million and also had an additional unreimbursed \$9 million in settlement expense.

In October 2006, Qualcomm sued its excess D&O insurer seeking compensatory damages as well as a judicial declaration that the excess carrier was obligated to indemnify Qualcomm for more than \$9 million in unreimbursed expenses. The excess carrier contended, among other things, that the underlying policy had not been "exhausted" as required by the excess policy. The excess policy's exhaustion clause provided that the excess carrier "shall be liable only after the insurers under each of the Underlying policies have paid or have been held liable to pay the full amount of the Underlying Limit of Liability."

The trial court held that the excess policy had not been triggered, and Qualcomm appealed. On appeal, Qualcomm argued that an excess carrier was liable for losses exceeding the actual limits of underlying primary insurance, even where the primary carrier settled for less than its actual policy limit. Qualcomm also argued that denying excess coverage would be contrary to public policy, because such a denial would work a forfeiture, provide a windfall to the excess carrier, and encourage litigation by discouraging settlement.

The court of appeals declined "to reach a broad holding on public policy considerations" and instead concluded that "the literal policy language in this case governs." The court said that the excess policy was not triggered because Qualcomm's pleadings "establish that the primary insurer neither paid the 'full amount' of the liability limit nor had it become legally obligated to pay the full amount of the primary limit." The court said that the exhaustion clause here compels us to conclude that the parties expressly agreed that [the primary carrier] was required to pay (or be legally obligated to pay) no less than

\$20 million as a condition of [the excess carrier's] liability. Because [the primary carrier] did not so pay, [the excess carrier's obligations] did not arise.

The *Qualcomm* decision is consistent with the *Comerica* case, which the *Qualcomm* court said presented "factual circumstances almost identical to those present in this case." This developing line of case authority has important implications both for the claims resolution and for the insurance acquisition process.

These cases demonstrate that it is in the policyholder's interest to aim towards global compromises that simultaneously resolve all liability insurance issues, including issues concerning the excess coverage.

Discussion

These case developments have a number of important implications. First, each of these courts expressly noted that they reached their decisions in reliance upon policy language and absent other language to the contrary. The inference is that different excess policy language could have produced a different result. That is, the specific wording of excess liability insurance policies – even so-called follow form excess liability insurance policies – matters.

One particularly important area of concern, as demonstrated in the *Comerica* and *Qualcomm* cases, is the excess policy's exhaustion language. There clearly is a need for more flexible language, to reduce restrictions surrounding the kinds of payments of loss that could trigger the excess carrier's payment obligation. Many excess D&O carriers now offer exhaustion trigger language that reduces the restrictions on the kinds of payments that could trigger the excess carrier's payment obligation. Careful attention is necessary, as carriers have varying exhaustion-triggering language.

Second, in each of these cases, the policyholders reached separate compromises with the primary carrier, leaving potential issues with the excess carriers open and unresolved. These cases demonstrate that it is in the policyholder's interest to aim towards global compromises that simultaneously resolve all liability insurance issues, including issues concerning the excess coverage. D&O claims situations are notoriously complex, and in any given case circumstances may frustrate a policyholders' attempt to form a global claims resolution. But in many cases, a global resolution may be feasible, particularly if the policyholder maintains effective communications with all participants throughout the claims process.

Third, given the increasing importance of excess insurance in D&O claims resolution, these issues are likely to become even more critical. It is not in anyone's interests for excess coverage disputes to become a routine part of the D&O claims process. Indeed,

everyone involved in the D&O insurance industry, including excess D&O insurers, have an interest in avoiding adverse claims outcomes.

Notwithstanding the industry's interests in avoiding adverse claims outcomes, the fact remains that in the three cases cited above, the excess liability carriers not only took positions adverse to their policyholders, but in each case the carriers prevailed and their respective policyholders were forced to absorb losses for which they thought they had insurance. Accordingly, the final and most important lesson from these cases is that policyholders must actively protect their interests in every step of the insurance process, from policy negotiation to claims resolution.

Conclusion

Excess D&O insurance is an increasingly important part of the D&O claims process. There are important steps that policyholders can take, both in connection with the insurance acquisition and as part of the claims resolution processes, to try to reduce disputes with excess D&O carriers. The increasing prominence of these issues underscores the importance of involving skilled insurance professionals in both the insurance transaction and in the claims process.

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A version of this article previously appeared on The D&O Diary, the author's Internet weblog. You can access the blog via our website at www.oakbridgeins.com. To monitor developments on this and other important topics relating to directors' and officers' liability, readers are encouraged to refer to The D&O Diary regularly.

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