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Excess Insurers' Right to Challenge The Primary Insurers' Claim Adjustment

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Follow Form Insurance Policies

- Most insurance programs that provide more than $10M of protection have at least one excess layer of coverage
- Excess policies are often referred to as “follow form” implying that they simply follow the terms and conditions of the primary policy form… This is dangerously misleading.
- Notwithstanding the name, few policies are truly follow form.
- Even minor differences between the primary and excess policies can lead to significant gaps in coverage.

Examples of how failure to negotiation an excess policy may result in a loss of coverage:

- Attachment Exhaustion Provision
  - Excess policies only attach once the underlying limit is fully exhausted
  - What counts as exhaustion?
  - Who can pay?
  - What happens if there is a compromise due to a coverage dispute?
  - Shaving of limits provisions
  - Reasons why a discount may not apply to an excess policy (choice of law provision, defense costs issues, etc.).

- Arbitration Provision
  - Some policies require coverage disputes be resolved by arbitration rather than litigation.
  - This can be an issue if excess policies have different requirements.
  - Laws of a state, versus UNCITRAL arbitration rules, London Arbitration Act of 1996, etc.
  - Can lead to multiple battles on multiple fronts with potentially inconsistent results.

Examples of how failure to negotiation an excess policy may result in a loss of coverage:

- Definitions may be inconsistent
  - Definition of Claim
  - Definition of Loss
  - Definition of Insured
- Extended Reporting Period
  - Differences in the cost or term of an Extended Reporting Period can lead to significant issues.
- Cancellation Provision
  - Some excess policies allow carriers to cancel the policy for any reason or no reason at all.
- Appeals Provision
  - Some policies allow the insurer to appeal a decision even if the insured has no desire to do so.
  - This can be a problem – especially if the appeal results in additional losses and defense costs above the limit of coverage

Follow-form excess carriers: challenging deference to primary insurer's coverage decisions

Presented by: Nathan B. Lee (Gray Duffy LLP) and Elizabeth L. Taylor (Reed Smith LLP)
March 1, 2022

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Excess carriers' responsibility to assess coverage

Excess carriers have an independent, good-faith responsibility to assess coverage for their policyholders, even if:

- Primary carrier denies coverage
- Policy is follow-form

The duty is non-delegable

Obtaining defense coverage from excess carriers

Policyholders can sometimes obtain defense coverage from excess carriers when the primary carrier wrongfully denies defense coverage.

- Certain policy language imposes a “drop down” obligation
- Reasonable expectations
- An insurer cannot “follow form” to a wrongful denial

IMG Worldwide, Inc. v. Westchester Fire Ins. Co.

IMG Worldwide, Inc. v. Westchester Fire Ins. Co., 572 F. App'x 402 (6th Cir. 2014)

- Excess policy provided for duty to defend if primary policy "does not provide coverage."
- The term "provide" can include "provide for" or "undertake to deliver."
- The court applied the second definition, construing the policy against the insurer-drafter to include a wrongful denial. Thus, the excess insurer owed a duty to defend.
- The court based its decision on the policyholder's "reasonable expectations."

Excess carriers' right to challenge coverage and settlement decisions made by primary carriers

No independent right to challenge coverage and settlement decisions made by primary carriers, unless:

- Fraud
- Bad faith (on the part of the primary carrier)
- Express contractual right to do so

This rule is also couched in upholding the policyholder's reasonable expectations of coverage.

Erosion of underlying limits

- “Improper erosion” is a concept created by insurers.
- Courts reject “improper erosion” arguments in most circumstances.
- From a policyholder perspective, there is no such thing as “improper” erosion.
- Courts focus on policyholders’ reasonable expectations.

Ninth Circuit decisions

Ninth Circuit cases

Two recent Ninth Circuit cases help underscore the very limited circumstances under which an excess carrier may dispute payment decisions and coverage determinations made by the primary carrier.

- *AXIS Reinsurance Co. v. Northrop Grumman Corp.*, 975 F.3d 840 (9th Cir. 2020)
- *Scottsdale Ins. Co. v. Certain Underwriters at Lloyds*, 839 F. App'x 105 (9th Cir. 2020)

In all circumstances, courts may step in to protect the policyholder's reasonable expectations.

AXIS Reinsurance vs. Northrop Grumman

- 2 lawsuits filed against Northrop alleging ERISA violations
- Northrop settles both lawsuits out of Court, and tendered both settlements to its insurers for coverage
- Northrop had multi-layer program of employee benefit fiduciary liability insurance including (1) $15M primary with National Union; (2) $15M excess insurance policy with CNA; (3) $15M secondary excess insurance policy with AXIS
- As a secondary excess insurer, AXIS only required to drop down to provide coverage but only after underlying insurance policies had been exhausted

AXIS Reinsurance vs. Northrop Grumman (cont'd)

- National Union determined that the first settlement fell under its primary insurance policy, which covered loss from actual or alleged wrongful acts by Northrop or its employees, including violations of ERISA
- National Union paid a portion of the first settlement, exhausting its $15M liability limit

AXIS Reinsurance vs. Northrop Grumman (cont'd)

- CNA agreed that the first settlement fell within its scope of coverage and dropped down and paid the remainder of the first settlement.
- CNA's partial payment did NOT exhaust its $15M liability limit. As such, AXIS was not required to pay any portion of the FIRST settlement.
- CNA covered subsequent second settlement, after it determined that the second settlement fell within its scope of coverage and exhausted the remainder of its $15M liability limit.

AXIS Reinsurance vs. Northrop Grumman (cont'd)

- AXIS was then asked to pay the remainder of the second settlement.
- AXIS did not contest the validity of the second settlement under the terms of its excess policy, and AXIS covered its portion of the second settlement.
- AXIS notified Northrop that it intended to seek reimbursement of the first settlement amount on the ground that these earlier payments by National Union and CAN were "not for covered loss."
- Of note, the AXIS excess policy did NOT contain a provision for AXIS to challenge the propriety of payments by underlying insurers for "covered loss."

AXIS Reinsurance vs. Northrop Grumman (cont'd)

- AXIS argued "improper erosion"
- AXIS sought reimbursement of the insurance payment it made as a secondary excess insurer to Northrop
- The District Court agreed and initially granting AXIS's Motion for Summary Judgment

AXIS Reinsurance vs. Northrop Grumman (cont'd)

- Northrop appeals to Ninth Circuit, arguing that AXIS assumed the risk that Northrop's primary and excess insurers might adjust claims in a manner that would trigger AXIS's secondary excess coverage
- Ninth Circuit reversed
- An excess insurer may not challenge that underlying limits should not have been exhausted absent a showing of fraud or bad faith, or the specific reservation of such a right in its contract with the insured

Ninth Circuit's ruling in *Axis*:

- Ninth Circuit focus on Reasonable Expectations
- No reasonable insured in Northrop's position would understand that it might have to argue justify its underlying insurers' payment decisions as a prerequisite to obtaining excess coverage from AXIS

Challenging prior payments – insurer perspective

- What type of policy language can you include to reserve the right to challenge prior payments?
  - *AXIS Surplus Ins. Co vs. Innisfree Hotels, Inc. (*S.D. Ala. Oct 6, 2006) (noting that “the Axis Excess Policy . . . states that amounts paid by underlying insurance for losses that would not have been payable under the Axis Excess Policy do not count towards the $10 million" liability limit and "*do not erode* the $10 million threshold“.

Challenging prior payments – policyholder perspective

- What can policyholders expect?
  - Watch for policies containing language like that in *AXIS v. Innisfree Hotels*.
  - Work with coverage counsel when placing coverage, and involve both primary and excess carriers in any active disputes likely to result in judgments or settlements

Costco Wholesale v. Arrowood

- Third layer excess insurer contended that its policy should not have been triggered as the underlying insurers should have refused to pay some or all of the $30 million in attorney's fees and costs submitted to them in relation to a $8 million class action settlement between Costco and its employees. Id. at 1173.
- The *Costco* court held that generally, an excess insurer may not second-guess the coverage determinations of the underlying insurers, absent an indication of fraud, bad faith, or a contractual right to interfere in their adjustment processes.
- The *AXIS v. Northrop* court relied on *Costco*.

Costco Wholesale v. Arrowood (cont'd)

- Permitting "improper erosion" claims would undermine the confidence of both insureds and insurers in the dependability of settlements," thereby eliminating one of the primary incentives for obtaining insurance.
- Inefficiencies in the insurance industry
- Little benefit for policyholders.
- Little evidence of insurance companies paying out claims (let alone their policy limits) when they are not obligated to do so.

Scottsdale Ins. Co. v. Certain Underwriters at Lloyds

- Insured ("Dickstein") had purchased a primary policy from Lloyds and an excess policy from Scottsdale.
- After one of Dickstein's partners was sued for malpractice, Lloyds refused to defend.
- Dickstein sued Lloyds for coverage, and for bad faith failure to defend.

Scottsdale Ins. Co. v. Certain Underwriters at Lloyds (continued)

- Lloyds reached a settlement with Dickstein to dispose of all claims
  - Lloyds allocated the $16.5 million settlement as follows:
    - $11.74 million from the primary policy
    - $1.26 million for “extra-contractual liability”
    - $4.5 million to be paid by Scottsdale

Scottsdale Ins. Co. v. Certain Underwriters at Lloyds (continued)

- Scottsdale challenged Lloyds allocation and sought a determination that the settlement did not erode the limits of the primary policy
- Lloyds invoked *Northrop Grumman*, arguing that Scottsdale could not contest underlying erosion of limits

Scottsdale Ins. Co. v. Certain Underwriters at Lloyds (continued)

- Scottsdale, on the other hand, argued that the bad faith failure to defend claims were against *Lloyds* – not the insured – and it had not contractually undertaken to cover those claims
- The court agreed with Scottsdale, finding that anything paid out to settle the bad faith or failure to defend claims was not part of the policy limits, but rather should have been considered "extra contractual liability" for Lloyds

Reasonable expectations

- Critically, in *Scottsdale* as in *Northrop*, allowing Scottsdale to contest Lloyds allocation also protected the insured's reasonable expectations
  - An insured never expects a bad faith denial of coverage
    - Primary carriers should not be permitted to offload liability for bad faith onto excess carriers
    - But, insureds are not left holding the bag

Reasonable expectations

- Scottsdale challenged Underwriters allocation of the settlement, arguing that Lloyds should have to pay the full settlement. Scottsdale was not arguing that the policyholder should not receive the full settlement

Key takeaways

Takeaways for insurers

- In sum, absent a contractual provision, excess insurers may not contest the payments of other insurers for earlier claims unless there is evidence that those payments were motivated by fraud or bad faith.

- From the insurer's perspective, to protect themselves, excess insurers should consider either 1) requesting higher premiums or 2) inserting specific policy language reserving their right to contest "improper erosion" by the underlying insurers under certain conditions, so long as such a provision does not conflict with applicable law or public policy.

Takeaways for policyholders

- Follow form policies generally adhere to the wording of primary policies, but:
  - Excess carriers have an independent good faith duty to evaluate coverage
  - Excess carriers may have to drop down to provide defense costs in certain circumstances
  - Excess carriers cannot challenge underlying exhaustion of limits absent fraud, bad faith, or an express right to do so
- Insureds should watch out for policy language giving carriers the purported right to challenge underlying exhaustion

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Thank You

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