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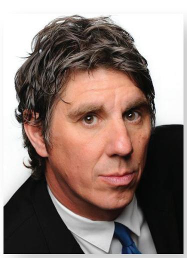
Excess Insurance Policies and the Effect of Insolvency on Exhaustion Clauses and "Drop Down" Coverage

The recent economic recession in the U.S. has impacted the practice of insurance law in many ways, not the least of which has been the effect of massive insolvency on insurance coverage issues. Many self-insured companies and primary insurers fell into bankruptcy during this time creating insurance coverage issues for their excess carriers. While in bankruptcy, of course, self-insured companies and insurers were largely protected from tort claims by the automatic stay, including catastrophic claims. Often times during bankruptcy, many claimants who have been left without recovery or even unsatisfied judgments, sought redress outside of the bankruptcy court. They pursued the excess carrier by way of declaratory judgment for "drop down" coverage to cover unsatisfied claims from dollar one. Because of the recent increases in insolvencies, this issue has again come to the forefront in insurance policy drafting and insurance litigation. Excess policies vary considerably and courts rely on different policy provisions in reaching different results on this issue in various jurisdictions around the country.

The requirements and formulas that determine exhaustion of the coverage limits or retentions in the primary layer are often what determine the rights and obligations of an excess carrier in those cases. Generally, the insured's primary coverage must be exhausted by actual payment of the policy limit amount. In some cases, however, the policyholder can settle for less than the underlying policy limit, absorb the gap between the settlement and the primary limit, and then seek coverage from the excess insurer for the balance. The scenarios can vary significantly, and both decisional law as well as policy construction will ultimately determine the excess carrier's duties and obligations under each circumstance. In addition, it is important to understand that courts regularly confuse an excess carrier's obligation to pay under the excess policy following the exhaustion of the primary limits with the limits of liability section of the policy, which is what courts should rely on to determine if there is "drop down" coverage to begin with.

The Second Circuit's decision in *Zeig v. Massachusetts Bonding & Insurance Co.* is an interesting decision often cited for the proposition described above, 23 F.2d 665 (2nd Circuit 1928). The Court in *Zeig* found that construing the excess policy's exhaustion clause to mean that the plaintiff in the underlying tort claim actually had to collect the full policy limit was "unnecessarily stringent." *Id.* at 666. The court reasoned that the defendant, the excess insurer, had "no rational interest in whether the insured collected the full amount of the primary policies,



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so long as it was only called upon to pay such portion of the loss as was actually in excess of the limits of those policies." Id. The court weighed the implications of construing the exhaustion clause "[t]o require an absolute collection of the primary insurance to its full limit," finding that such interpretation would often result in "delay, promote litigation, and prevent an adjustment of disputes, which is both convenient and commendable." *Id.*

A more recent California appellate case held that *Zeig* did not apply where an excess policy had specific clauses regarding full payment by the primary layer of insurance prior to the triggering of the excess carrier's obligations. *Qualcomm, Inc. v. Certain Underwriters at Lloyd's, London.* 161 Cal. App. 4th 184, 199 (2008). The court there found that Zeig and its progeny contained "the policy rationale favoring the efficient settlement of disputes between insurers and insureds, a rationale that in our view cannot supersede plain and unambiguous policy language [citations omitted]." *Id.*

Insolvency of the primary layer of insurance can certainly affect the ability of tort claimants to collect proceeds, thereby impacting exhaustion of underlying policy limits. A Seventh Circuit case followed an Illinois state court decision in noting that "in cases of insolvency, the retained limit language means that an excess insurer is not obliged to pay costs that would otherwise be borne by the insolvent insurer, but instead is only responsible for providing coverage in excess of the underlying policy limits. *Premcor USA, Inc. v. Am. Home Assur. Co.*, 400 F.3d 523 (7th Circuit 2005) citing *Donald B. MacNeal, Inc. v. Interstate Fire & Casualty Co.*, 477 N.E.2d at 1325 (quoting Molina v. U.S. Fire Ins. Co., 574 F.2d 1176, 1178 (4th Cir. 1978)). This holding aligns with the *Zeig* decision in that excess coverage, depending on the specific policy language, only requires the excess carrier to pay anything above the primary layer's coverage amount, but not to "drop down" and cover from the first dollar owed.

Interestingly and somewhat dangerously, some courts have liberally interpreted excess policy language with the terms "collectible" or "recoverable" to require the excess insurer to drop down in the event of the primary insurer's insolvency and cover from dollar one of the primary policy. In a widely publicized Massachusetts Supreme Court case, the court resolved an ambiguity resulting from the aforementioned terms in favor of the insured, requiring an excess carrier to "drop down" to indemnify an insolvent primary insurer. *Gulezian v. Lincoln Ins. Co.*, 399 Mass. 606, 611-612 (1987). Importantly, the court there also noted that "[i]t seems likely that the [excess carrier] did not contemplate the insolvency of a scheduled underlying insurer in drafting its policy. The phenomenon of the insolvency of an insurer is not, however, so rare as to excuse that omission of attention to detail." Thus, the court does place some burden on the excess carrier to write policies with some care to avoid ambiguities resulting in an unintended coverage requirement. *See also Reserve Ins. Co. v. Pisciotta,* 640 P.2d 764, 772 (Cal. 1982); *MacNeal, supra; Lechner v. Scharrer,* 145 Wis. 2d 667 (1988). There are a number of courts across the country that have agreed in principle with *Gulezian* and its progeny and have found drop down coverage to exist under similar circumstances.

The idea behind these rulings is that when the excess carrier uses such terms as "collectible" or "recoverable" in describing the lower limit in its excess policies, from the insured's point of the view, the excess carrier will only provide excess coverage when the primary limit is collectible or recoverable, but presumably will provide primary or drop down coverage when it is not collectible or recoverable. While the excess policies containing this language do not specifically say that, courts have held that as an excess carrier, it is imperative to avoid any ambiguity that might lead the insured to believe there could be primary or "drop down" coverage by the excess carrier in the event of an insolvency. *See also Morbark Industries v. Western Employers Insurance*, 170 Michigan App. 603, 429 N.W.2d 213 (Mich. Ct. App. 1988).

Other courts have found exactly the contrary. In a Seventh Circuit ruling, the court concluded that the excess carrier "did not contract to bear the risk of the primary carrier's insolvency, nor do its premiums reflect the cost that the assumption of this risk would entail." *Zurich Ins. Co. v. Heil Co.*, 815 F.2d 1122, 1126. In *Radiator Specialty Co. v. First State Ins. Co.*, the court similarly held that "[i]t would simply make no sense to hold that an 'excess' insurer should be liable as a primary insurer due to a primary insolvency. This would impose a liability on the 'excess' insurer which is not bargained for in its premium that is based on the lesser risk which an excess carrier agrees to assume." 651 F. Supp. 439, 442 (1987).

While state and federal decisions remain split and incongruous on the issue depending on the federal circuit or the state jurisdiction, it is clear that most courts rely heavily on an interpretation of the policy language itself to determine the outcome in these declaratory judgment actions. As such, it is imperative that excess carriers employ policy language that will protect them from having to subsume the risk and cost of the underlying policy and to avoid drop down coverage from dollar one. There is no doubt that insolvencies of primary carriers and self-insured entities are not only possible but probable in this economic environment. Excess carriers who continue to incorporate ambiguous language in their policies on the lower limit of coverage open themselves up to insurance coverage litigation as well as possible indemnity exposure for large sums not contemplated by their premiums. P