CHAPTER FOURTEEN

EXCESS AND EXTENDED COVERAGES AND EXCESS COVERAGE ISSUES

Michael C. Cannata, Esq.
Frank Misiti, Esq.*

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[14.0] I. INTRODUCTION

The relationship between primary and excess insurers can at times be uncertain and complex. Excess insurance is written to apply to an insured's loss after the primary policy obtained by an insured is exhausted. The limits of liability of the excess policy only cover a loss after the limits of the primary policy have been paid, either to settle the loss or to indemnify the insured as a result of an adverse judgment. Thus, the policies—primary and excess—are interrelated. The language of each policy will control the outcome in a wide variety of contested issues between primary and excess insurers. This chapter will discuss various issues in the excess insurance arena.

[14.1] II. EXCESS COVERAGE AND THE EXHAUSTION REQUIREMENT

Excess insurers write their coverages and charge premiums based on an important consideration, namely, that their coverage will be implicated only after all applicable primary and/or underlying coverages are exhausted. Excess insurance policy language differs and can vary greatly from policy to policy. The common principle, however, is that excess insurance coverages cannot be reached until the limits of the underlying insurance are exhausted, either to settle the loss or indemnify the insured as a result of an adverse judgment.

[14.2] A. When Does Exhaustion Occur?

[14.3] 1. The Effect of Settlement by the Primary Insurer for an Amount Less Than the Primary Limits as Triggering Excess Coverage

[14.4] a. Jurisdictions Where Settlement for Less Than the Primary Limits Is Deemed Exhaustion

In New York, there is precedent establishing that an excess insurer's policy may be triggered by a settlement between the primary insurer and the insured for an amount less than the amount of the limits of the primary insurance. In other words, the primary policy can be exhausted by a settlement for less than the primary limits.[1]

1 *Zeig v. Mass. Bonding & Ins. Co.*, 23 F.2d 665 (2d Cir. 1928).

In *Zeig*[2] the insured had three burglary insurance policies providing a total of $15,000 in primary coverage. The excess insurer's policy provided coverage in the amount of $5,000 as excess, not contributing, insurance to apply and cover only after all other insurance therein referred to had been "'exhausted in the payment of claims to the full amount of the expressed limits'" of such other insurance.[3] The insured settled its burglary claims against its primary insurers for $6,000 and presumably released them for the full amounts of their policies. The excess insurer argued that it was not required to contribute to the insured's loss because, in order for the primary insurance to be exhausted, the insured must actually collect the full amount of the policy limits. The court ruled that the primary policies were exhausted, and the excess insurer would be required to contribute to the insured's loss in excess of $15,000, the limits of the primary policies, not the amount of the loss in excess of the cash settlement.[4] In so holding, the court reasoned that the particular contract language at issue provided only "that it be 'exhausted in the payment of the claims to the full amount of the expressed limits.' The claims are paid to the full amount of the policies, if they are settled and discharged, and the primary insurance is thereby exhausted."[5]

Other jurisdictions have followed *Zeig* and concluded that settlement by a primary insurer for less than its primary limits can exhaust the primary

2 *Id.*

3 *Id.* at 666.

4 *Id.*

5 *Id.*

limits. Further, these jurisdictions have extended the *Zeig* holding to situations involving liability insurance contracts and third-party liability cases.[6]

6 *See Stargatt v. Fidelity & Cas. Co.*, 67 F.R.D. 689, 690 (D. Del. 1975) (citing *Zeig*, the court ruled that a settlement by the primary insurer for less than its policy limits exhausts that policy and the excess insurer is responsible for covered losses in excess of the primary limits plus any deductible; exhaustion of the primary limits does not mean when those limits have been actually paid but rather means "entirely used up" and the primary policy is "entirely used up" by settlement), *aff'd*, 578 F.2d 1375 (3d Cir. 1978); *see also Allstate Ins. Co. v. Riverside Ins. Co.*, 509 F. Supp. 43 (E.D. Mich. 1981) (settlement between the insured and the primary insurer for less than the primary insurer's limits exhausts that policy and excess insurer's coverage was triggered as to that portion of any judgment above the amount of the primary policy limits); *Christiana Gen. Ins. Corp. of N.Y. v. Great Am. Ins. Co.*, 979 F.2d 268, 278 (2d Cir. 1992) (citing *Zeig* for the proposition that an "excess carrier must pay claims to extent its layer is pierced even though underlying carrier settled with insured for less than the full amount of underlying carrier's liability"); *Pereira v. Nat'l Union Fire Ins. Co.*, 2006 WL 1982789 (S.D.N.Y. 2006) (citing *Zeig*, the court rejected the argument that an insurance policy provision required actual exhaustion of previous layers as a condition precedent for the payment of excess coverage); *Trinity Homes LLC v. Ohio Cas. Ins. Co.*, 629 F.3d 653, 659–60 (7th Cir. 2010) (following *Zeig* and holding that where an underlying insurer paid 75% of its limit of liability and the insured paid the remaining 25%, the underlying policy was exhausted); *The Mills Ltd. P'ship v. Liberty Mut. Ins. Co.*, 2010 Del. Super. LEXIS 563, *28 (Del. Super. Ct. 2010) (following *Zeig* and holding that the underlying policies were exhausted as a matter of law where the underlying insurers were held liable to pay the full amount of their limits of liability, but where the insured settled for approximately 82% of these limits); *Maximus, Inc. v. Twin City Fire Ins. Co.*, 856 F. Supp. 2d 797, 804 (E.D. Va. 2012) (citing *Zeig*, the court held that ". . . [insured's] settlements with the underlying insurers for less than the full limits of their respective policies and agreeing to fill the gap so that the policy limits have been reached satisfies the [excess insurance policy's] exhaustion requirement."); *Lexington Ins. Co. v. Tokio Marine & Nichido Fire Ins. Co.*, 2012 U.S. Dist. LEXIS 59635, *10 (S.D.N.Y. Mar. 28, 2012) (following *Zeig* and stating "[i]n absence of unambiguous language requiring exhaustion via full payment of the underlying policy, no such exhaustion is required"); *Mass. Mut. Life Ins. Co. v. Certain Underwriters at Lloyd's of London*, 2014 Del. Super. LEXIS 373, 24 (Del. Super. Ct. 2014) (following *Zeig* and noting that viewing the exhaustion clause less dogmatically and practically works to the advantage of the insured and insurer alike); *see also Ali v. Fed. Ins. Co.*, 719 F.3d 83 (2d Cir. 2013). In *Ali,* the Second Circuit observed that under the liability policy provisions at issue, to reach the excess insurer's attachment points, actual liability payments—not merely defense or indemnity obligations—must reach the applicable attachment points. In *Ali,* the insureds argued that the excess insurers that issued policies above other insolvent excess insurers were triggered ". . . once the total amount of [the insureds'] defense and/or indemnity *obligations* exceeds the limits of any insurance policies underlying their respective policies, regardless of whether such amounts have actually been paid by those underlying insurance companies." *Id.* at 87 (emphasis in original). The Second Circuit rejected that argument and held that "[t]he plain language of the relevant excess insurance policies requires the 'payment of losses'—not merely the accrual of liability—in order to reach the relevant attachment points and trigger the excess coverage." *Id.* at 94 (emphasis in original). *See also Futch v. Fid. & Cas. Co.*, 246 La. 688, 166 So. 2d 274 (La. 1964); *Deblon v. Beaton*, 103 N.J. Super. 345, 247 A.2d 172 (Law Div. 1968); *Loy v. Bunderson*, 107 Wis. 2d 400, 320 N.W.2d 175 (Wis. 1982); *Teigen v. Jelco of Wis., Inc.*, 124 Wis. 2d 1, 9, 367 N.W.2d 806 (Wis. 1985); *Kelley Co., Inc. v. Cent. Nat'l Ins. Co.*, 662 F. Supp. 1284 (E.D. Wis. 1987); and Ostrager & Newman, Handbook on Insurance Coverage Disputes, § 13.04 (15th ed. 2009) (observing that "the reasoning of *Zeig* has been frequently followed" and citing cases).

[14.5] b. Jurisdictions Where Settlement for Less Than the Primary Limits Is Not Deemed Exhaustion of the Primary Policies

In *United States Fire Insurance Co. v. Lay*,[7] the Seventh Circuit held that a settlement for less than the primary limits does not exhaust the primary policy. Thus, the court ruled that an excess insurer's coverage will not be triggered unless the primary insurer has *actually paid* the amount of its limits. In so holding the court stated:

> [w]e can conceive of good reasons for an excess carrier to be unwilling to accept liability unless the amount of the primary policy has actually been paid. A settlement for less than the primary limit that imposed liability on the excess carrier would remove the incentive of the primary insurer to defend in good faith or to discharge its duty . . . to represent the interests of the excess carrier.[8]

[14.6] 2. The Trigger of Excess Coverage as a Result of the Exhaustion of Primary Coverage by Year or by Layer

Certain courts have addressed issues of vertical exhaustion or horizontal exhaustion (exhaustion by year or by layer, respectively). In *Associated International Insurance Co. v. St. Paul Fire & Marine Insurance Co.*,[9] for example, an insured who produced industrial safety equipment,

7 577 F.2d 421 (7th Cir. 1978).

8 *Id.* at 423; see 8A J. Appleman & J. Appleman, Insurance Law and Practice § 4909 pp. 390–93 (1979 and Supp. 1987); *Bettenburg v. Emps. Liab. Assurance Corp.*, 350 F. Supp. 873, 877 (D. Minn. 1972) (settlement by primary insurer with plaintiff for an amount within its limits did not exhaust the primary policy); *Smith v. Gov't Emps. Ins. Co.*, 1976 OK 190, 558 P.2d 1160, 1162 (Okla. 1976) (settlement by the primary insurer for an amount within its policy limits does not exhaust the primary policy and the excess coverage is not triggered); *Allstate Ins. Co. v. Brown*, 736 F. Supp. 705 (W.D. Vir. 1990) (settlement by the primary insurer that did not exhaust the primary limit did not trigger the excess insurance policy); *Gencorp Inc. v. AIU Ins. Co.*, 138 Fed. Appx. 732 (6th Cir. 2005) (insured's action against excess insurers dismissed on summary judgment in light of insured's settlement with primary and umbrella insurers for less than full coverage limits.); *Qualcomm, Inc. v. Certain Underwriters at Lloyd's London*, 161 Cal. App. 4th 184, 73 Cal. Rptr. 3d 770 (2008) (insured's settlement with primary insurer for less than the primary insurer's policy limit did not trigger excess coverage); *Intel Corp. v. Am. Guar. & Liab. Ins. Co.*, 2010 U.S. Dist. LEXIS 139903, *31 (N.D. Cal. Dec. 7, 2010) (observing that "in Qualcomm, a California Court of Appeal rejected expressly the placement of 'policy considerations . . . above the plain meaning of the terms of the excess policy.'"); *Intel Corp. v. Am. Guar. & Liab. Ins. Co.*, 51 A.3d 442, 450 (Del. 2012) (observing that "[w]e find *Zeig* inapplicable here as well: the plain language of the policy controls."); *Cooper v. Certain Underwriters at Lloyd's*, 716 Fed.Appx. 735 (9th Cir. 2018) ("This forecloses the possibility of exhaustion through payment by parties other than the underlying insurers.").

9 220 Cal. App. 3d 692, 269 Cal. Rptr. 485 (Cal. Ct. App. 1990) (unpublished).

including masks and respiratory systems used by construction workers for sandblasting, was sued by numerous workers who alleged they acquired silicosis as a result of using the insured's defective products over an extended period of time. Between 1952 and 1983, the insured had successive primary, first-level and second-level excess liability coverage and sought coverage for the numerous claims against it. Associated, who had provided second-level excess coverage for one year, argued that all the primary insurance contracts, implicated by the claims asserted by the insured, must be exhausted before excess coverage for any year could be triggered. The court disagreed, holding that "neither an excess nor a primary insurer should be required to pay for the portion of injury attributable to a period outside the defined limits of its own coverage."[10] Therefore, there is "no reason why an excess insurer should not be required to contribute for that portion of a continuous injury that occurs during its policy year" once the primary policy for that period is exhausted.[11]

In contrast, in *Stonewall Insurance Co. v. City of Palos Verdes Estates*,[12] the insured, the city, was sued by a resident for damages caused by the city's actions over an extended period of time. The city sued its primary and excess insurers to recover the amount it paid to the resident in the underlying case. One of the city's excess insurers also commenced suit to recover from the city and the primary insurers the amount it contributed to the judgment against the city in the underlying case. The court found that "if . . . the aggregate of the policy amounts of the primary policies in effect . . . is adequate to cover the [insured's] obligation to [claimant], then no excess carrier is liable for any of that obligation."[13]

10 *Id.* at 488–89.

11 *Id.* at 488; *see Ducre v. Mine Safety Appliances Co.*, 645 F. Supp. 708 (E.D. La. 1986), *aff'd*, 833 F.2d 588 (5th Cir. 1987) (primary carrier responsible to provide coverage for each year during which a plaintiff was exposed to silica dust up to the per-person limits in effect for that particular year, similarly, in any year in which primary limits are insufficient to meet a judgment, the excess carriers shall be liable up to their policy limits on a yearly basis).

12 46 Cal. App. 4th 1810, 54 Cal. Rptr. 2d 176 (Cal. Ct. App. 1996).

13 *Id.* at 1826; *see also Cont'l Cas. Co. v. Rohr, Inc.*, 2018 WL 1885393, 2018 Conn. Super. LEXIS 614 (Conn. Super. Ct. Mar. 19, 2018) (". . . liability under excess policies generally does not attach until all primary policies have been exhausted.").

[14.7] B. Does an Excess Insurer Have a Duty to "Drop Down" and Provide Primary Coverage in the Event of a Primary Insurer's Insolvency?

Insurer insolvency was relatively uncommon until the early 1980s. However, insurer insolvency increased dramatically in the eighties, and, as it became more common, insureds attempted to remedy the resulting gaps in their insurance by looking to their excess coverages. Thus, insureds began to argue that an excess insurer must "drop down" below the intended triggering amount that was specified in order for excess coverage to be implicated, to provide primary coverage to the insured when the primary insurer is insolvent. In other words, insureds may argue that when a primary insurer is insolvent, that policy should be deemed exhausted, requiring the excess insurer to "fill the gap." Various cases across the country have decided this precise issue. Most of the decisions focus on the specific contract language at issue and, thus, have produced different outcomes.

In New York, when a primary insurer becomes insolvent, the excess insurer is not obligated to "drop down" and provide coverage below its intended layer to the insured.[14] In *Ambassador*, both the trial court and the First Department concluded that the specific policy language was unambiguous and clearly set forth the point at which excess insurance coverage would be provided.[15] At issue in *Ambassador* was policy language providing that

> [t]he . . . Company agrees to pay on behalf of the Insured *the Ultimate Net Loss in excess of the Underlying Insurance* as shown in Item 4 of the Declarations [which list[ed] the Mission Insurance policy], but only up to an amount not exceeding the company's Limit of Liability as shown in Item 3 of the Declarations [i.e., $15,000,000].[16]

14 *Ambassador Assocs. v. Corcoran*, 143 Misc. 2d 706, 541 N.Y.S.2d 715 (Sup. Ct., N.Y. Co. 1989), *aff'd*, 168 A.D.2d 281, 562 N.Y.S.2d 507 (1st Dep't 1990), *aff'd*, 79 N.Y.2d 871, 581 N.Y.S.2d 276 (1992); *see 200 Fifth Ave. Owner, LLC v New Hampshire Ins. Co.*, Index No. 104141/11, 2012 N.Y. Misc. LEXIS 2731, *14 (Sup. Ct., N.Y. Co. June 5, 2012) (". . . simply because the primary insurer is unable to pay does not automatically trigger the excess insurer's obligations.").

15 *Id.* at 709

16 *Id.* at 708.

Ultimate net loss was defined as the following: "[T]he amount payable in settlement of the liability of the Insured after making deductions for all recoveries and for other valid and collectible insurance, excepting however the policy(ies) of the Underlying Insurer(s)."[17]

The court rejected the insured's arguments that the policy was ambiguous. In so holding, the court ruled that the

> excess insurer first becomes liable when the limits of the underlying insurance have been exceeded; its coverage is only activated when the loss exceeds the amount specified in the underlying policies. . . . Were the courts to impose upon excess insurers the risk of an underlying insurer's insolvency, it would, in effect, "transmogrify the policy into one guaranteeing the solvency of whatever primary insurer the insured might choose."[18]

This holding was consistent with a line of New York authority which held that an excess insurer is not required to drop down to the primary limits and provide coverage in the event the primary insurer becomes insolvent.[19] In *Pergament Distributors, Inc. v. Old Republic Insurance Co.,* the policy was quoted as providing the following:

> "The Company hereon shall only be liable for the ultimate net loss the excess of either
>
> "(a) the limits of the underlying insurances as set out in the attached schedule in respect of each occurrence covered by said underlying insurances [$1,000,000], or
>
> "(b) the amount as set out in Item 2(c) of the Declarations [$10,000] ultimate net loss in respect of each occurrence not covered by said underlying insurances."[20]

The plaintiff asserted that the terms "covered" and "not covered" were ambiguous, arguing that they must be construed against the excess insurer to mean that the excess insurer must drop down and provide coverage for

17 *Id.*

18 *Id.* at 710 (citations omitted).

19 *See Pergament Distribs., Inc. v. Old Republic Ins. Co.*, 128 A.D.2d 760, 513 N.Y.S.2d 467 (2d Dep't 1987).

20 *Id.* at 761.

any amounts incurred above the insured's deductible, because when a claim is not paid as a result of the primary insurer's insolvency, it is "not covered."[21] In rejecting this argument and holding that the umbrella insurer was not required to drop down and defend the plaintiff, the court stated: "At bar, there is only one reasonable interpretation of the preceding terms. When used in this context, the terms 'covered' and 'not covered' refer to whether the policy insures against a certain risk not whether the insured can collect on an underlying policy."[22]

[14.8] III. CONFLICTING "OTHER INSURANCE" CLAUSES IN EXCESS OR UMBRELLA POLICIES

[14.9] A. Common "Other Insurance" Clauses Generally

"Other insurance" clauses are clauses that purport to govern the relationship between insurance policies that cover the same insured and the same risk. The rights of coinsurers depend in large part on the specific language used in the concurrent insurance contracts.

[14.10] B. Conflicting Clauses in Excess Policies

When two or more excess insurance contracts purport to be excess of all other valid and collectible insurance, the insurers will prorate the amount of the loss in excess of the primary coverage. The proration, generally, will be in proportion to the applicable policy limits.[23]

In *Aetna Casualty & Surety Co. v. Liberty Mutual Insurance Co.,* the Aetna policy provided excess insurance "over any other collectible insurance" and contained the provision that "where two or more policies cover on the same basis, either excess or primary, we will pay only our share. Our share is the proportion that the limit of our policy bears to the total of

21 *Id.*

22 *Id.* (citations omitted); *see American Re-Ins. Co. v. SGB Universal Builders Supply, Inc.*, 141 Misc. 2d 375, 379, 532 N.Y.S.2d 712 (Sup. Ct., N.Y. Co. 1988) (citation omitted) (excess insurer is not required to drop down when the primary insurer becomes insolvent. "Excess liability insurance is a low-cost method of providing extended protection where primary (and secondary) insurance leaves off; its premiums do not reflect the assumption of risk of the primary carrier's insolvency"); *Zurich-Am. Ins. Co. v. Mead Reins. Corp.*, 161 A.D.2d 403, 555 N.Y.S.2d 333 (1st Dep't 1990) (excess insurer was not required to drop down where the primary insurer became insolvent).

23 *Aetna Cas. & Sur. Co. v. Liberty Mut. Ins. Co.*, 91 A.D.2d 317, 459 N.Y.S.2d 158 (4th Dep't 1983).

the limits of all the policies covering on the same basis."[24] The Liberty Mutual policy provided "'excess insurance with respect to any loss against which the insured has other valid and collectible insurance.'"[25] Since each policy purported to be excess to the other, the court held that these clauses "cancel each other out"; the insurers were required to contribute to the loss on a pro rata basis in relation to policy limits.[26]

[14.11] C. Conflicting Clauses in General or Excess Umbrella Insurance Contracts

Applying a rigid rule requiring pro rata apportionment of liability in relation to an insurer's policy limits sometimes creates an unfair result. This problem occurs, for example, where an umbrella contract and a "true excess" policy both cover the same risk.

Generally where an umbrella contract is involved, it should properly be considered excess to a "true excess" policy. Likewise, the umbrella contract also would become excess to other applicable primary policies that, as a result of a contingency clause, are converted into excess policies. An order of priority must be established among the applicable policies. The leading New York case concerning these issues is *Lumbermens Mutual Casualty Co. v. Allstate Insurance Co.*[27]

In *Lumbermens*, four insurance policies provided coverage for the same automobile accident. Allstate provided primary insurance to the corporation that was the owner of the involved auto. Allstate also had issued a policy to the driver's mother, which provided coverage to the insured's relatives if involved in an auto accident while driving a non-owned automobile. This policy specifically provided that "'[i]f there is other insurance . . . the insurance with respect to a . . . non-owned automobile shall be excess insurance over any other collectible insurance.'"[28] The third policy, likewise through Allstate, was issued to the driver's father. It pro-

24 *Id.* at 325.

25 *Id.*

26 *Id.*; *see Jefferson Ins. Co. v. Glens Falls Ins. Co.*, 88 A.D.2d 925, 450 N.Y.S.2d 888 (2d Dep't 1982) (where there were two excess insurance policies, and each purported to be excess to the other excess coverage clauses—they canceled each other out and each insurer contributed in proportion to its policy limits); *see also Cont'l Cas. Co. v. Aetna Cas. & Sur. Co.*, 823 F.2d 708 (2d Cir. 1987) (applying Connecticut law); *Am. Home Assurance Co. v. Hartford Ins. Co.*, 74 A.D.2d 224, 427 N.Y.S.2d 26 (1st Dep't 1980).

27 51 N.Y.2d 651, 435 N.Y.S.2d 953 (1980).

28 *Id.* at 654.

vided that Allstate would be responsible for and pay the "'net loss in excess of the insured's retained limit.' The term `retained limit' was . . . defined as 'the sum of applicable limits of underlying policies listed in Schedule A . . . and the applicable limits of any other underlying insurance collectible by the insured.'"[29] This policy also provided that "[t]he insurance afforded under this policy shall apply as excess insurance not contributory to other collectible insurance (other than insurance applying as excess to Allstate's limit of liability hereunder) available to the Insured and covering loss against which insurance is afforded hereunder."[30] The fourth policy was a "catastrophe policy" issued by Lumbermen to the corporate entity under whose name the automobile was registered. It provided coverage in excess of "'any other valid and collectible insurance available to the insured, whether such other insurance is stated to be primary, contributing, excess or contingent.'"[31]

Allstate argued that the last three policies (the mother's, father's and registrant's) all provided excess or secondary coverage, and all existed on the same level of insurance. Thus, Allstate argued that each insurer should contribute pro rata to the loss in proportion to their respective policy limits. The Court of Appeals recognized that such a method of apportionment is the general rule where there are multiple excess policies covering the same risk and each purports to be excess to the other. The Court found, however, "this rule is inapplicable" to the case before it, because "its use would effectively deny and clearly distort the plain meaning of the terms of the policies. . . ."[32]

The Court established an order of priority for the policies, as follows. Once the primary policy was exhausted, the policy issued to the mother should contribute next; then, if and when the limits of that policy have been exhausted, the policy issued to the father should be called upon to

29 *Id.*

30 *Id.* at 655.

31 *Id.*

32 *Id.*

contribute. Only after these policies have been exhausted, should the catastrophe policy issued by Lumbermens be summoned into effect.[33]

[14.12] IV. DUTY TO DEFEND ON THE PART OF AN EXCESS INSURER

[14.13] A. Instances Where an Excess Insurer May Be Obligated to Defend an Insured: Policy Language

In New York, an excess insurer's duty to defend will be governed by the applicable policy language. Thus, where the excess policy specifically provides that it will not be obligated to defend the insured unless the claim is not covered by the underlying policy, the excess insurer was not obligated to contribute to the insured's defense. In *Schulman Investment Co. v. Olin Corp.*,[34] the policy stated that it would indemnify the insured for its ultimate net loss in excess of the retained limit. The policy defined "retained limit" in part as "[a]ll expenses incurred by the insured in the investigation, negotiation, settlement and defense of any claim or suit seeking such damages, excluding only the salaries of the insured's regular employees, provided 'ultimate net loss' shall not include any damages or expense because of liability excluded by this policy."[35]

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33 *Id.* at 656. *See Argonaut Ins. Co. Inc. v. U.S. Fire Ins. Co.*, 728 F. Supp. 298 (S.D.N.Y. 1990); *Pub. Serv. Mut. Ins. Co. v. Firemen's Fund Am. Ins. Co.*, 82 A.D.2d 403, 441 N.Y.S.2d 677 (1st Dep't 1981), *aff'd*, 55 N.Y.2d 868, 448 N.Y.S.2d 154 (1982); 8A J. Appleman & J. Appleman, Insurance Law and Practice § 4909.85, pp. 452-54 (rev. ed. 1981); *accord Allstate Ins. Co. v. Emp'rs Liab. Assurance Corp.*, 445 F.2d 1278 (5th Cir. 1971) (holding that the umbrella policy did not contribute with the other excess policies and was therefore not triggered unless and until the other excess policies were exhausted); *CNA Ins. Co. v. Hartford Ins. Co.*, 129 N.H. 243, 247, 525 A.2d 722 (N.H. 1987) ("An umbrella excess third-party liability policy is a unique form of coverage unlike any other form of excess coverage. It is excess over any other coverage and it does not contribute with any other excess coverage for pro rata contribution purposes."); *see also State Farm Fire and Cas. Co. v. LiMauro*, 65 N.Y.2d 369, 375–76, 492 N.Y.S.2d 534 (1985) (holding that if a policy expressly negates contribution from other carriers, "or otherwise manifests that it is intended to be excess over other excess policies" then that policy does not contribute pro-rata with other excess policies); *Am. Family Mut. Ins. Co. v. Regent Ins. Co.*, 288 Neb. 25, 57, 846 N.W.2d 170, 194 (Neb. 2017) ("[U]mbrella policies, as the only true excess insurance policies, incur liability only after the exhaustion of all other policies, including primary policies containing excess insurance clauses.").

34 514 F. Supp. 572 (S.D.N.Y. 1981); *Farm Family Mut. Ins. Co. v. Allstate Ins. Co.*, 179 A.D.2d 965, 966, 579 N.Y.S.2d 207 (3d Dep't 1992) ("to [qualify] as being considered a higher layer of coverage than the standard excess coverage, such a status must be shown by the presence of plain language in the policy to that effect establishing whether ratable contribution was bargained for in the policy.").

35 *Schulman Inv. Co.*, 514 F. Supp. at 574.

The policy further provided that it did not apply to defense, investigation, settlement or legal expenses covered by underlying insurance. The court ruled that the excess insurer would not have a duty to defend or pay for the insured's defense unless and until the insured proved that the claim fell outside the scope of coverage of the primary policy.

However, where a policy is silent as to when an excess insurer's defense obligation is triggered, the excess insurer may be obligated to contribute to the defense of the insured on a pro rata basis where the judgment or settlement reaches or appears likely to reach its policy limits. *In dicta,* at least one New York court has stated the following:

> [w]here an excess insurer is liable to indemnify in part, either because the amount of the judgment or settlement exceeds the limits of the primary policy or because an apportioned part of such judgment or settlement is for claims which are excluded from the primary policy but are covered by the excess policy, the excess insurer may be liable for a portion of the legal fees.[36]

Where the excess policy contains an express duty to defend, the excess insurer will not be required to contribute to the insured's defense unless the amount recovered by the plaintiff in the underlying action exceeds the primary insurer's policy limits. In such cases, contribution will be on a pro rata basis in proportion to the respective policy limits.[37]

36 *Sanabria v. Am. Home Assurance Co.*, 113 A.D.2d 193, 197, 495 N.Y.S.2d 533 (3d Dep't 1985), *rev'd on other grounds*, 68 N.Y.2d 866, 508 N.YS.2d 416 (1986) (citation omitted). *See also Hertz Corp. v. Gov't Emps. Ins. Co.*, 250 A.D.2d 181, 683 N.Y.S.2d 483 (1st Dep't 1998) (relying on *Sanabria* to hold that the excess insurance company was liable for a portion of the legal fees, but that the excess insurer's policy also provided it would defend any suit for damages, even if the claim or suit was groundless.).

37 *Bettenburg v. Emps. Liab. Assurance Corp.*, 350 F. Supp. 873 (D. Minn. 1972); *Mandell Corp. v. Ins. Co. of N. Am.*, 125 Misc. 2d 390, 479 N.Y.S.2d 452 (Sup. Ct., Queens Co. 1984); *Russo v. Rochford*, 123 Misc. 2d 55, 472 N.YS.2d 954 (Sup. Ct., N.Y. Co. 1984). *See also Nationwide Mut. Ins. Co. v. Travelers Ins. Co.*, 8 A.D.3d 861, 862, 779 N.Y.S.2d 153 (3d Dep't 2004) (generally where the terms regarding payment obligations in two or more policies conflict, "insurers must contribute in the proportion their policies bear to the limit of coverage at that level.") *Johnson Controls, Inc. v. London Market*, Wis. App. LEXIS 404 (Feb. 19, 2009) (certifying issue to the Wisconsin Supreme Court of whether an excess insurer whose policy does not contain express duty to defend has an implied duty to defend based upon "follow form" provisions in its policy), *cert. granted, Johnson Controls, Inc. v. London Market*, 316 Wis. 2d 721, 765 N.W.2d 581 (2009), *aff'd*, 325 Wis. 2d 176, 784 N.W. 2d 579 (2010).

The New York Court of Appeals, in *General Motors Acceptance Corp. v. Nationwide Insurance Co.*,[38] reiterated a fundamental statement respecting the duty to defend as between primary and excess insurers. It concluded that the duty to defend an insured rests with the primary insurer and that the primary insurer is not entitled to contribution from an excess insurer. The Court rejected the argument that an equitable allocation between primary and excess insurers must be realized and further held that, under the circumstances of the particular facts presented, both "coincidental primary policies" were required to equally share in the payment of defense costs. In relevant part the Court stated:

> [w]e are mindful of the fact that these polices were both coincidental primary policies. Primary insurance premiums are based, at least in part, on the insurer's consideration that it may be liable to defend an action. In this sense, "primary" policy premiums are higher . . . than "excess" premiums, because the primary insurer contemplates defending a potential lawsuit when it contracts with the insured. A primary insurer's duty to defend is not diminished, . . . nor is it entitled to defend an action less vigorously, simply because its policy limits are more easily exceeded in any given case. Relieving primary insurers of this duty to defend would provide a windfall to the carrier insofar as the costs of defense . . . are contemplated by, and reflected in, the premiums charged for primary coverage. This is in contrast to a true excess, or "umbrella," policy, where the duty to defend is not as readily triggered.[39]

[14.14] B. The Duty to Defend on the Part of the Excess Insurer after Exhaustion of the Primary Policy Limits

An interesting question is presented when the limits of the primary insurance are exhausted. The primary insurer will argue that the excess insurer should assume the defense of the insured. In New York, an excess

38 4 N.Y.3d 451, 796 N.Y.S.2d 2 (2005).

39 *Id.* at 457; *see also Purdue Frederick Co. v. Steadfast Ins. Co.*, 40 A.D.3d 285, 836 N.Y.S.2d 28 (1st Dep't 2007) (holding that an excess carrier may protect its interest by participating in the defense but is under no obligation to do so.); *Barber v. RLI Ins. Co.*, 2008 U.S. Dist. LEXIS 104128, *5–6 (N.D.N.Y. Dec. 24, 2008) (observing that "[a]n excess insurer may participate in the defense to protect its interest, but the law does not obligate it to do so.").

insurer may not be required to assume the defense of the insured when the primary insurance contract is silent respecting the primary insurer's defense obligation in the event of exhaustion of the primary policy limits.

For example, in *American Employers Insurance Co. v. Goble Aircraft Specialties, Inc.*,[40] the court held that the primary insurer's duty to defend continues even after exhaustion of policy limits. Rejecting the insurer's arguments that once its policy limits are exhausted it was not required to continue the defense of any action then pending or any new actions thereafter commenced, the court stated that, since the contract did not make "the defense provisions dependent upon the exhaustion of the specified coverage,"[41] the insurer was obligated to continue to defend the insured, even after policy limits are exhausted. The holding takes an anomalous turn and requires the primary insurer to defend new actions brought against the insured even after the policy limits have been exhausted.[42]

Thus, unless expressly provided in the primary insurer's policy that exhaustion terminates its defense obligation, and assuming the excess policy contains an express provision that it will not assume the insured's defense, the excess insurer likely will not be required to assume the defense of the insured.[43] Courts in California, and many other jurisdictions, have held contrary to *American Employers Insurance Co.*[44] The California cases clearly state that once a primary insurer's policy limits are exhausted its defense obligation ends, and the excess insurer must assume the insured's defense even if the primary policy does not specifically provide that the primary insurer's duty to defend does not continue

40 205 Misc. 1066, 131 N.Y.S.2d 393 (Sup. Ct., N.Y. Co. 1954).

41 *Id.* at 1073.

42 *Id.; see Md. Cas. Co. v. W.R. Grace & Co.*, 794 F. Supp. 1206 (S.D.N.Y. 1991), *rev'd*, 23 F.3d 617 (2d Cir. 1993) (holding that based upon *American Employers* that "the duty to defend survives the exhaustion of the policy limits"). *See also Royal Ins. Co. v. Lexington Ins. Co.*, 2004 WL 1620877 (S.D.N.Y. 2004) (holding that tender of the policy limits does not extinguish the primary's duty to defend); *see also Am. Home Assur. Co. v. Port Auth. of N.Y. & N.J.*, 40 Misc. 3d 1236(A), 980 N.Y.S.2d 274 (Sup. Ct., N.Y. Co. 2013) (granting insured summary judgment where policy did not contain a provision terminating defense costs upon exhaustion).

43 *See Commercial Union Ins. Co. v. Pittsburgh Corning Corp.*, 553 F. Supp. 425 (E.D. Pa. 1981), *aff'd in part, rev'd in part*, 789 F.2d 214 (3d Cir. 1986); *St. Paul Fire & Marine Ins. Co. v. Thompson*, 150 Mont. 182, 433 P.2d 795 (Mont. 1967); *Kocse v. Liberty Mut. Ins. Co.*, 159 N.J. Super. 340, 387 A2d 1259 (N.J. 1978); *Liberty Ins. Underwriters Inc. v. Camden Clark Mem. Hosp. Corp.*, 2009 WL 4825199 (S.D. W. Va. Dec. 8, 2009).

44 *Allstate Ins. Co. v. Montgomery Trucking Co.*, 328 F. Supp. 415 (N.D. Ga. 1971); *Aetna Cas. & Sur. Co. v. Certain Underwriters at Lloyd's of London*, 129 Cal. Rptr. 47, 56 Cal. App. 3d 791 (Cal. Ct. App. 1976); *Nat'l Union Ins. Co. v. Phoenix Assurance Co.*, 301 A.2d 222 (D.C. App. 1973); *Lumbermen's Mut. Cas. Co. v. McCarthy*, 90 N.H. 320, 8 A.2d 750 (N.H. 1939).

once its policy limits are exhausted.[45] The intricacies involved in ascertaining the respective duties to defend between a primary and excess insurer are illustrated by *Millers' Mutual Insurance Ass'n v. Iowa National Mutual Insurance Co.*[46] There, Millers provided the insured with primary coverage for bodily injury and property damage. Iowa National provided the insured with excess coverage. The Iowa National excess policy stated that

> [w]hen underlying insurance does not apply to an occurrence . . . [i]n the event that the limits of liability of the underlying insurance . . . are exhausted by [an] occurrence, the company shall be obligated to assume charge of the settlement or defense of any claim or proceeding against the insured resulting from the same occurrence. . . .[47]

Various property damage and bodily injury suits were commenced against the insured. They clearly presented the possibility of judgments in excess of both the primary and excess policy limits. Both insurers filed an interpleader suit and deposited the amounts of their policy limits into court. Subsequently Millers, the primary insurer, filed a declaratory judgment action seeking a declaration that by depositing its money to the court, it was relieved of its duty to defend. The judge in that action ruled that Millers' deposit of its policy limits into court did not relieve Millers of its obligation to defend the insured. Millers then brought a declaratory judgment action in Colorado seeking a declaration that Iowa National, as an excess insurer, had an obligation to share pro rata in settlements and costs of defense already incurred and to be incurred in the future.

The court ruled that "the condition precedent to Iowa's duty to defend has occurred [because] Millers' policy limits have been 'exhausted by [an] occurrence. . . .' The plain meaning of 'exhaustion' in the Iowa insurance contract includes exhaustion by way of interpleader."[48] Thus, Iowa

45 *See Aetna Cas. & Sur. Co.*, 129 Cal. Rptr. 47; *State of California v. Continental Ins. Co.*, 15 Cal. App. 5th 1017, 1034, 223 Cal. Rptr. 3d 716 (Cal. Ct. App. 2017) *citing Cmty. Redev. Agency v. Aetna Cas. & Sur. Co.*, 50 Cal. App. 4th 329, 57 Cal. Rptr. 2d 755 (Cal. Dist. Ct. App. 1996) ("It is settled under California law that an excess or secondary policy does not cover a loss, nor does any duty to defend the insured arise, until *all* of the primary insurance has been exhausted") (emphasis in original).

46 618 F. Supp. 301 (D. Colo. 1985).

47 *Id.* at 302.

48 *Id.* at 304.

National was required to contribute to the continuing defense of the insured on a pro rata basis with Millers.[49] In so holding, the court expressly rejected the result reached by the California Supreme Court in *Signal Cos., Inc. v. Harbor Insurance Co.*[50]

In *Signal,* the exhaustion of the primary policy and settlement of all claims against the insured occurred simultaneously. Thus, once the claims were settled by payment from the primary insurer there no longer was the need for a continuing defense; that is, no claims existed against the insured. Since the excess insurer's liability only attached after exhaustion of the primary insurer and all the defense costs were incurred prior to exhaustion, the excess insurer, although it contributed to the settlement, was not required to contribute to defense costs.

In *Aetna Casualty & Surety Co. v. Certain Underwriters at Lloyd's of London,*[51] the primary policy limits were exhausted by settlement of claims on behalf of the insured. When the primary policy limits were exhausted, the primary insurer requested that the excess insurers take over the defense of the insured. The excess insurer refused, and the primary insurer continued to defend. Thereafter, the primary insurer instituted a declaratory judgment seeking to recover the additional defense costs paid by it after its policy had been exhausted. The court ruled that, since the primary insurer's duty to defend ended when it paid its full policy limits to the insured, the excess insurers were liable for the additional defense costs, unless the duty to defend is clearly and expressly excluded by the policy language.[52] In 1966, the Insurance Services Office devised the following policy language, which many policies now contain: "The insurer shall not be obligated to pay any claim or judgment or defend any suit after the applicable limit of [the insurer's] liability has been exhausted by payment of judgments or settlements."

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49 *Id.* at 305.

50 612 P.2d 889, 27 Cal. 3d 359 (Cal. 1980).

51 129 Cal. Rptr. 47, 56 Cal. App. 3d 791 (Cal. Ct. App. 1976).

52 *See Pac. Indem. Co. v. Fireman's Fund Ins. Co.*, 175 Cal. App. 3d 1191, 223 Cal. Rptr. 312 (Cal. Ct. App. 1985) (primary insurer's duty to defend ended upon payment of its $1 million policy limits, and excess insurers were responsible for continuing defense costs); *see also Flintkote Co. v. General Accident Assur. Co.*, 2008 U.S. Dist. LEXIS 108245, 90 (N.D. Cal. Aug. 6, 2008) ("... unless excess policies provide otherwise, once primary coverage is unavailable, the *defense* burden shifts to the excess insurer even if its policy does not expressly provide for defense coverage") (emphasis in original).

This language apparently prevents a court from finding that the primary insurer's duty to defend continues after exhaustion; and, if the excess insurer's policy does not expressly exclude a duty to defend, a court would likely determine that the excess insurer is obligated to assume the defense of the insured.[53]

[14.15] V. DUTY OF THE PRIMARY INSURER TO THE EXCESS INSURER TO SETTLE A CLAIM WITHIN POLICY LIMITS

The relationship between a primary and excess insurer is oftentimes the subject of controversy when the primary insurer unreasonably fails to settle within policy limits.

Generally, an insurer owes a duty of good faith to its insured when considering settlement proposals. Thus, if a primary insurer rejects a reasonable settlement within policy limits and a verdict in excess of the limits of the primary policy is returned, the insured may have a cause of action against the primary insurer to recover any judgment amount the insured is required to pay in excess of the primary policy limits. Likewise, where an insured has excess liability coverage, the primary insurer's failure to settle may expose the excess insurer to liability for a verdict beyond the primary limits. Case law has developed concerning the precise issues raised by this relationship between primary and excess insurers.

[14.16] A. An Excess Insurer's Direct Right of Action Against a Primary Insurer That Wrongfully Refuses to Settle a Claim

In New York, a primary insurer owes an independent duty of good faith to an excess insurer, which provides the excess insurer with a direct right of action against the primary insurer. The New York Court of Appeals has held that the primary insurer "owed to . . . the excess carrier the same duty

53 *See Pac. Indem. Co.*, 175 Cal. App. 3d 1191; *Aetna Cas. & Sur. Co.*, 129 Cal. Rptr. 47 (When the primary limits are exhausted, an implied duty to assume the defense of the insured exists on the part of the excess insurer in the absence of express language in the policy to the contrary).

to act in good faith which [the primary] owed to its own insureds."[54] The Court affirmed the First Department's decision in *Michigan Mutual Insurance Co.*, which stated: "As primary insurer, it acts as a fiduciary and is held to an exacting standard of utmost good faith. Any such right of action arises as a result of the *independent* and *direct duty* to the excess insurer."[55]

[14.17] B. Equitable Subrogation

The doctrine of equitable subrogation recognizes that an excess insurer is subrogated to the rights of the insured. Thus, where the primary insurer unreasonably refuses to settle a claim and a verdict is returned against the insured in excess of the primary policy limits (which reaches the excess insurance), the excess insurer can recover from the primary insurer the amount the excess insurer must pay on the verdict. Most courts that have allowed recovery by an excess insurer from a primary insurer have done so pursuant to this theory.

Peter v. Travelers Insurance Co.[56] set forth the elements of an excess insurer's cause of action based on equitable subrogation. The following elements have been established by *Peter* and subsequent cases that have addressed the issue of equitable subrogation:

> (1) The insured has suffered a loss for which the party to be charged is liable, either because the latter is a wrongdoer whose act or omission caused the loss or because he is legally responsible to the insured for the loss caused by the wrongdoer; (2) the insurer in whole or in part has compensated the insured for the same loss for which the party

54 *Hartford Accident & Indem. Co. v. Mich. Mut. Ins. Co.*, 61 N.Y.2d 569, 574, 475 N.Y.S.2d 267 (1984); *California Union Ins. Co. v. Excess Ins. Co.*, 780 F. Supp. 1010, 1012 (S.D.N.Y. 1991) ("[i]n the context of settlements this duty [of good faith] obligates an insurer to attempt to settle a claim where liability is clear and the potential for recovery far exceeds the primary coverage limit."); *Federal Ins. Co. v. North Am. Specialty Ins. Co.*, 83 A.D.3d 401, 402, 921 N.Y.S.2d 28 (1st Dep't 2011) (primary insurer's duty of good faith extends to excess insurer when insurer is exposed to liability); *Quincy Mut. Fire Ins. Co. v. New York Cent. Mut. Fire Ins. Co.*, 89 F. Supp. 3d 291, 306 (N.D.N.Y. 2014) ("An insurer's duty of good faith is not limited to the insured, extending to excess carriers where the primary insurer is defending in a case in which both insurance companies have provided coverage.").

55 *Hartford Accident & Indem. Co. v. Mich. Mut. Ins. Co.*, 93 A.D.2d 337, 342, 462 N.YS.2d 175 (1st Dep't 1983) (emphasis added); *see Hartford Accident & Indem. Co. v. Commercial Union Ins. Co.*, 751 F. Supp. 345 (E.D.N.Y. 1990) (direct right of action by excess insurer against primary insurer for breach of duty of good faith exists pursuant to New York law); *accord St. Paul Fire & Marine Ins. Co. v. U.S. Fid. & Guar Co.*, 43 N.Y.2d 977, 404 N.Y.S.2d 552 (1978).

56 375 F. Supp. 1347 (C.D. Cal. 1974) (citation omitted).

> to be charged is liable; (3) the insured has an existing, assignable cause of action against the party to be charged, which action the insured could have asserted for his own benefit had he not been compensated for his loss by the insurer; (4) the insurer has suffered damages caused by the act or omission upon which the liability of the party to be charged depends; (5) justice requires that the loss should be entirely shifted from the insurer to the party to be charged, whose equitable position is inferior to that of the insurer; and (6) the insurer's damages are in a stated sum, usually the amount it has paid to its insured, assuming the payment was not voluntary and was reasonable.[57]

In *Continental Casualty Co. v. Reserve Insurance Co.*,[58] the Supreme Court of Minnesota held a primary insurer liable to the excess insurer in the amount of its policy limits. The excess insurer contributed $200,000 to a $750,000 settlement and requested that the primary insurer contribute its policy limits of $50,000 to the settlement. The primary insurer refused, and the excess insurer brought suit to collect the $50,000 policy limits from the primary insurer. The court ruled that "an excess insurer is subrogated to the insured's rights against a primary insurer for breach of the primary insurer's good-faith duty to settle,"[59] reasoning as follows:

> "In the case of excess coverage, the primary insurer should be held responsible to the excess insurer for improper failure to settle, since the position of the latter is analogous to that of the insured when only one insurer is involved." When there is no excess insurer, the insured becomes his own excess insurer, and his single primary insurer owes him a duty of good faith in protecting him from an excess judgment and personal liability. If the insured purchases excess coverage, he in effect substitutes an excess insurer for himself. It follows that the excess insurer should assume the rights as well as the obligations of the insured in that position.[60]

57 *Id.* at 1350 (citation omitted).

58 307 Minn. 5, 238 N.W.2d 862 (Minn. 1976).

59 *Id.* at 8 (citation omitted).

60 *Id.* at 8–9 (citation omitted).

The Supreme Court of Michigan has also recognized the excess insurer's right to seek recovery from the primary insurer, based on equitable subrogation.[61] In discussing the policy considerations at hand, the court stated the following:

> [A]llowing the excess insurer to enforce the primary insurer's duty to settle in good faith serves the public and judicial interests in fair and reasonable settlement of lawsuits by discouraging primary carriers from "gambling" with the excess carriers' money when potential judgments approach the primary insurer's policy limits. Finally, the public interest in avoiding unnecessarily high insurance premiums is served by recognizing such a cause of action because, where the excess insurer is required to cover both primary and excess liability as a result of the primary insurer's breach of the duty to settle in good faith, policy rating structures are distorted, rendered uncertain, and made more expensive.[62]

While both direct right of action and equitable subrogation allow recovery by an excess insurer against a primary insurer for breach of the duty of good faith, equitable subrogation provides the excess insurer with only those rights that the insured possesses against the primary insurer. This distinction can prevent recovery by the excess insurer from the primary insurer in certain situations. For example, in *Puritan Insurance Co. v. Canadian Universal Insurance Co.*,[63] the primary insurer determined that the action against the insured should not be settled because there was simply no liability on the part of the insured. The insured, represented by its own counsel, concurred with the primary insurer's judgment that the case should not be settled. A verdict was returned that reached the excess insurer's policy limits. The excess insurer commenced an action against the primary insurer premised upon the primary insurer's bad faith in failing to settle the action.

The court dismissed the excess insurer's complaint because the excess insurer possessed only those rights the insured had against its primary insurer. Since the insured, through counsel, had concurred with the pri-

61 *Commercial Union Ins. Co. v. Med. Protective Co.*, 426 Mich. 109, 393 N.W.2d 479 (Mich. 1986).

62 *Id.* at 119 (citations omitted); *see Valentine v. Aetna Ins. Co.*, 564 F.2d 292, 298 (9th Cir. 1977); *Portland Gen. Elec. Co. v. Pac. Indem. Co.*, 579 F.2d 514 (9th Cir. 1978).

63 775 F.2d 76 (3d Cir. 1985).

mary insurer that the action should not be settled, the insured would be estopped by its own conduct from suing the primary insurer to recover the amount of the judgment in excess of the primary policy limit. In a direct right of action jurisdiction, however, recovery by the primary from the excess would have been allowed.

[14.18] C. Triangular Reciprocity

Because of the limitations inherent in the doctrine of equitable subrogation, one court creatively developed the doctrine of "triangular reciprocity" to fashion a remedy for an excess insurer against the primary insurer based on bad faith.

Transit Casualty Co. v. Spink Corp.[64] involved a primary insurer and an insured that refused to accept a settlement that was wholly within the primary's limits. Trial ensued; the jury returned a verdict well above the policy limits of the primary insurer, which reached the excess insurer's limits. The excess insurer then sued the primary insurer and the insured to recover the amount of the excess judgment. Since the insured also had refused to settle, the excess insurer would have been unable to recover from the primary insurer pursuant to the theory of equitable subrogation. The court held, however, that the insured, the primary insurer and the excess insurer each owed the other reciprocal duties to act in good faith.[65] The court's reasoning was as follows:

> Applied to the interacting settlement obligations of a policyholder, his primary insurer, and his excess insurer, these principles produce the following formulation: The parties occupy a three-way relationship, which regardless of privity gap may engender reciprocal duties of care in the conduct of settlement negotiations; when a damage claim threatens to exceed the primary coverage, the reasonable foreseeability of impingement on the excess policy creates a three-way duty of care; if the plaintiff in an ensuing failure-to-settle suit has been contributorily neg-

64 156 Cal. Rptr. 360, 94 Cal. App. 3d 124 (Cal. Ct. App. 1979); *see also Russo v. Rochford*, 123 Misc. 2d 55, 472 N.Y.S.2d 954 (Sup. Ct., Queens Co. 1984). *Russo* applied triangular reciprocity to the duty to defend. *Russo* cited exclusively from *Transit Casualty* and stated that the "triangular reciprocity duty of care was also seen as promoting the 'sharing of the loss according to the measure of each party's comparative fault.'" *Id.* (internal citations omitted). The court weighed the relative degrees of fault and considered between the insurers the portion of the total liability each insurer was responsible for in order to fix percentages of fault. *Id.*

65 *Transit Cas. Co.*, 94 Cal. App. 3d 124.

> ligent, that plaintiff's damage recovery from the other parties will be proportionately reduced; if all three parties have been negligent, their individual shares of the total loss may be fixed in a single lawsuit.[66]

Thus, the court held that both the insured and the primary insurer breached their duties to the excess insurer to pursue and evaluate settlement proposals in good faith.

The proposition that the insured owes the excess insurer a duty to accept a good faith settlement was expressly disapproved by the Supreme Court of California in *Commercial Union Assurance Cos. v. Safeway Stores, Inc.*[67] Rather, the court stated, the excess insurer could assert a cause of action against the primary insurer pursuant to equitable subrogation only.[68] The court explained as follows:

> It has been held in California and other jurisdictions that the excess carrier may maintain an action against the primary carrier for [wrongful] refusal to settle within the latter's policy limits. This rule, however, is based on the theory of equitable subrogation: Since the insured would have been able to recover from the primary carrier for a judgment in excess of policy limits caused by the carrier's wrongful refusal to settle, the excess carrier, who discharged the insured's liability as a result of this tort, stands in the shoes of the insured and should be permitted to assert all claims against the primary carrier which the insured himself could have asserted.[69]

[14.19] D. Standards in Determining Bad Faith of a Primary Insurer

Most courts agree that the excess insurer must establish more than mere negligent conduct to establish a cause of action for bad faith failure

66 *Id.* at 134.

67 26 Cal. 3d 912, 610 P.2d 1038.

68 *Id.* (citations omitted).

69 *Id.* at 917–18.

to settle against the primary insurer.[70] Indeed, for other breaches of the duty to act in good faith, the focus usually is on the primary insurer's motivation. Where it is apparent that the primary insurer has protected its own interests in disregard of the excess insurers, a cause of action for bad faith will exist.[71] Interestingly, the Claims Executive Counsel, an organization composed of the American Insurance Association, the American Mutual Insurance Alliance and eight unaffiliated companies, in 1974 promulgated "The Guiding Principles for Primary and Excess Insurers." These "Guiding Principles" serve as a code of conduct for primary and excess insurers to follow:

> The primary insurer must discharge its duty of investigating promptly and diligently even those cases in which it is apparent that its policy limit may be consumed.
>
> Liability must be assessed on the basis of all relevant facts which a diligent investigation can develop and in light of applicable legal principles. The assessment of liability must be reviewed periodically throughout the life of a claim.
>
> Evaluation must be realistic and without regard to the policy limit.
>
> When from evaluation of all aspects of a claim, settlement is indicated, the primary insurer must proceed promptly to attempt a settlement, up to its policy limit if necessary, negotiating seriously and with an open mind.
>
> If at any time, it should reasonably appear that the insured may be exposed beyond the primary limit, the primary insurer shall give prompt written notice to the

70 *Valentine v. Liberty Mut. Ins. Co.*, 620 F.2d 583 (6th Cir. 1980); *N. River Ins. Co. v. St. Paul Fire & Marine Ins. Co.*, 600 F.2d 721 (8th Cir. 1979); *Centennial Ins. Co. v. Liberty Mut. Ins. Co.*, 62 Ohio St. 2d 221, 16 Ohio Op. 3d 251 (1980); *Global Aero., Inc. v. Hartford Fire Ins. Co.*, 354 Fed. Appx. 501 (2d Cir. 2009) (for the purposes of bad faith claims by excess insurers, a primary insurer's ordinary negligence or mistaken judgment does not establish gross disregard).

71 *Hartford Accident & Indem. Co. v. Mich. Mut. Ins. Co.*, 93 A.D.2d 337, 462 N.Y.S.2d 175 (1st Dep't 1983), *aff'd*, 61 N.Y.2d 569, 475 N.Y.S.2d 267 (1984); *see also Am. Alternative Ins. Corp. v. Hudson Specialty Ins. Co.*, 938 F. Supp. 908, 915 (C.D. Cal., 2013) ("[u]nder a theory of equitable subrogation, an excess insurer has a good faith obligation to a primary insurer to reasonably settle a case."); *Scottsdale Ins. Co. v. Indian Harbor Ins. Co.*, 994 F. Supp. 2d 438, 455 (S.D.N.Y. 2014) ("[u]nder New York law, a primary insurer's unrealistic settlement posture that exposes an excess carrier to risk is potentially significant evidence of bad faith.").

excess insurer, when known, stating the results of investigation and negotiation, and giving any other information deemed relevant to a determination of the exposure, and inviting the excess insurer to participate in a common effort to dispose of the claim.

Where the assessment of damages, considered alone, would reasonably support payment of a demand within the primary policy limit but the primary insurer is unwilling to pay the demand because of its opinion that liability either does not exist or is questionable and the primary insurer recognizes the possibility of a verdict in excess of its policy limit, it shall give notice of its position to the excess insurer when known. It shall make available its file to the excess insurer for examination, if requested.

The primary insurer shall never seek a contribution to a settlement within its policy limit from the excess insurer. It may, however, accept contribution to a settlement within its policy limit from the excess insurer when such contribution is voluntarily offered.

In the event of a judgment in excess of the primary policy limit, the primary insurer shall consult the excess insurer as to further procedure. If the primary insurer undertakes an appeal with the concurrence of the excess insurer the expense shall be shared by the primary and the excess insurer in such manner as they may agree upon. In the absence of such an agreement, they shall share the expense in the same proportions that their respective shares of the outstanding judgment bear to the total amount of the judgment. If the primary insurer should elect not to appeal, taking appropriate steps to pay or to guarantee payment of its policy limit, it shall not be liable for the expense of the appeal or interest on the judgment from the time it gives notice to the excess insurer of its election not to appeal and tenders its policy limit. The excess insurer may then prosecute an appeal at its own expense being liable also for interest accruing on the entire judgment subsequent to the primary insurer's notice of its election not to appeal. If the excess insurer does not agree to an appeal it shall not be liable to share the cost of any appeal prosecuted by the primary insurer.

> The excess insurer shall refrain from coercive or collusive conduct designed to force a settlement. It shall never make formal demand upon a primary insurer that the latter settle a claim within its policy limits. In any subsequent proceedings between excess insurer and primary insurer the failure of the excess insurer to make formal demand that the claim be settled shall not be considered as having any bearing on the excess insurer's claim against the primary insurer.

The Guiding Principles have limited application, have been subject to criticism, yet may serve to guide a court when determining the rights between primary and excess insurers. Few reported cases have discussed them.[72]

[14.20] VI. FOLLOWING FORM EXCESS COVERAGE

[14.21] A. Introduction

There is a type of excess insurance commonly referred to as "following form" coverage. This type of policy typically follows the form of the underlying policy and usually incorporates by reference the same terms, exclusions, additions and definitions as the specifically designated underlying policy. An example of a following form excess liability clause is as follows:

> The insurance afforded by this policy is subject to the same warranties, terms (including the terms used to describe the application of the limits of liability), conditions and exclusions as are contained in the underlying insurance on the effective date of this policy, except, unless otherwise specifically provided in this policy, any such warranties, terms, conditions, or exclusions relating to premium, the obligation to investigate and defend, the amount and limits of liability and any renewal agreement.

72 *See U.S. Fire Ins. Co. v. Nationwide Mut. Ins. Co.*, 735 F. Supp. 1320 (E.D.N.C. 1990) (stating that the Guiding Principles set forth the general standards of practice in the industry); *American Centennial Ins. Co. v. Warner-Lambert Co.*, 293 N.J. Super. 567, 681 A.2d 1241 (Law Div. 1995) (holding that the "Guiding Principles can be used to establish the standard of care which a primary insurer must use when settling a claim where an excess insurer may also be responsible for coverage"); *Royal Ins. Co. of Am. v. Reliance Ins. Co.*, 140 F. Supp. 2d 609 (S.D.S.C. 2001) (The "Guiding Principles" have been used by courts as at least an indication of insurance business practice and can be used to establish whether it is the custom of the industry to pay primary coverage to excess insurers and never to victims.).

[14.22] B. Following the Intent as Well as the Form of the Excess Policy

There is no question that excess policies containing the above following form clause, or similar following form language, follow the terms, conditions, exclusions and other language found in the underlying policy. Sometimes, however, after issuance of the excess and the underlying policy, the insured, and/or the underlying insurer, realizes that a mistake has been made in the insurance contract provisions. Oftentimes in such a situation, the underlying insurer and the insured will reform the underlying policy to reflect the parties' true intent. The question then becomes whether the excess insurer's policy also follows the intent (as reformed) of the underlying policy. No New York court has squarely addressed this issue. Since, however, this topic offers interesting implications, we borrow, for guidance, from other jurisdictions.

The Illinois Supreme Court has ruled that a following form excess insurer follows the intent of the underlying policy as well as the form. In *L.E. Myers Co. v. Harbor Insurance Co.*,[73] the excess insurer was bound by the reformation of the underlying primary policy. The reformation occurred subsequent to the issuance of the primary and excess policies to remedy a mutual mistake of fact between the primary insurer and the insured. The excess insurer was not a party to the reformation, and the following form clause in the excess policy provided coverage only for "loss for which the insured now has coverage under the underlying insurances."[74]

The court stated that use of the word "now" was not intended to prevent the parties from correcting mistakes that had been made in underwriting the policy.[75] In part, the court's decision was based on the fact that the excess insurer never reviewed the terms of the primary policy before it issued its own policy. Thus, the court explained, the excess insurer "could not have relied on the erroneously expressed instrument because [the following form insurer] never saw it until after the loss occurred.[76]

73 77 Ill. 2d 4, 394 N.E.2d 1200 (Ill. 1979).

74 *Id.* at 7.

75 *Id.* at 9.

76 *Id.* at 10.

Similarly, in *Great Atlantic Insurance Co. v. Liberty Mutual Insurance Co.*,[77] the excess insurer also was held bound by the reformed underlying policy. There, the primary insurer had issued two primary policies to the insured, each containing limits of $500,000. One policy was issued to cover the insured's American operations and the other to cover the insured's Canadian operations; however, these territorial limitations were not originally set forth in the policies. The excess insurer asserted that both underlying policy limits (totaling $1 million) applied to the underlying lawsuit before its policy would be reached. The court reformed the policies to set forth the specific territorial limits of each policy, and ruled against the excess insurer, because it had listed the applicable underlying coverage as $500,000 and, therefore, could not have relied upon the existence of two primary policy limits. Thus, it appears that there exists some modest support holding that the following form insurer follows the intent of the underlying policy, rather than the language.

[14.23] VII. NOTICE UNDER EXCESS POLICIES

Notice provisions contained in excess policies will often differ from notice provisions contained in primary insurance policies. The notice provision contained in an excess policy may require that the excess insurer be notified as soon as practicable of an "occurrence" which may result in a claim or suit under the excess policy and of a claim or suit against any insured that is "reasonably likely" to involve the excess policy.

While an issue may arise under an excess policy concerning exactly when an "occurrence" may result in a claim or suit under the excess policy or when a claim or suit against the insured is "reasonably likely" to involve the excess policy, New York courts have offered some guidance for determining these issues. In *Metropolitan Casualty Insurance Co. v. Travelers Insurance Co.*,[78] the Appellate Division, Second Department held that the insured became aware of an "occurrence" that was likely to involve the excess policy when the insured received a summons and complaint containing an ad damnum clause seeking damages in excess $2 million dollars, which was an amount in excess of the limit of liability of the underlying primary insurance policy.

77 773 F.2d 976 (8th Cir. 1985).

78 21 A.D.3d 457, 800 N.Y.S.2d 448 (2d Dep't 2005).

Likewise, in *Long Island Lighting Co. v. Allianz Underwriters Insurance Co.*,[79] the Appellate Division, First Department held that the insured became aware of the happening of an "occurrence" that was "reasonably likely" to involve certain excess policies when the insured received a letter from a claimant threatening a lawsuit over a polluted site that was known to likely cost $26.2 million. The insured argued that its liability would be subject to *pro rata* allocation under New York law and that this would serve to reduce the amount allocable in any one excess insurer's policy period, thereby making it unlikely that a claim would involve the excess policies. The First Department rejected this argument, reasoning that the insured, "offers no evidence that the timing of its notice was the result of a deliberate determination to that effect, and not, as the record suggests, the belief that it was not responsible for the [polluted site's] cleanup costs."

79 24 A.D.3d 172, 805 N.Y.S.2d 74 (1st Dep't 2005).