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FIFTH CIRCUIT DECISION PUTS EXCESS INSURER BACK IN LINE. BUT WILL IT CURB THE "REVERSE FOLLOW FORM" PHENOMENON?

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Insurance Policy In recent years, excess insurers have been challenging the constraints of their traditional "follow form" status by trying to influence how the underlying insurance must be paid out. After a string of judicial decisions favoring excess insurers, a decision issued by the Fifth Circuit Court of Appeals in June marks a victory for policyholders hoping to stem the "reverse-follow-form" phenomenon. But as traditional concepts of follow form excess coverage continue to erode, policyholders should remain vigilant when evaluating their excess coverage. **The Evolution of "Follow Form" Excess Coverage** Policyholders purchase "follow form" excess insurance to gain piece of mind. Indeed, the very words "follow form" convey an image of a coverage tower in which each successive layer sits atop and follows the underlying coverage without seams or gaps. But all too often that image doesn't comport with reality. Historically, follow form excess policies were single-page documents that simply identified the underlying policy and the amount of the excess limits. Today, such pure follow form policies are rare. They've largely been replaced by conditional follow form policies that still contain the words "follow form" in their title, but then put limits on the extent to which they actually follow the coverage provided in the underlying policy. Many excess policies do this by means of a broad statement that the excess coverage follows form *except* where the terms of the underlying policy are inconsistent with the terms of the excess policy. That conditional language is often followed by pages of excess-specific coverage terms, exclusions, conditions, and definitions that may make the nominally "follow form" excess coverage significantly different than the coverage provided by the underlying policy it purports to follow. Excess insurers are now going even further. Not content to merely control how their own coverage layers apply, excess insurers are trying to influence how the underlying insurance must be paid out. They do so by adding provisions to their excess policies that purport to restrict the way the underlying limits must be exhausted for the excess layer to attach. Because excess coverage only attaches after specified limits of underlying insurance are exhausted, a policyholder that doesn't want to risk forfeiting its excess coverage is under pressure to make sure the underlying limits are paid out in accordance with the exhaustion provisions of the excess policy. In effect, this creates a reverse-follow-form scenario, where the coverage provided by the underlying insurance may be dictated by the terms of the excess policy. Coincidentally, the evolution of this reverse-follow-form phenomenon is exemplified in a line of cases running from *Z[eig]* to *A[li].* **From *Z[eig]* to *A[li]* and Beyond** In *Zeig v. Massachusetts Bonding & Ins. Co.,* the Second Circuit held that a provision in an excess

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property insurance policy requiring the underlying limits be “exhausted in the payment of claims” did not require actual payment of the underlying limits and included “satisfaction of a claim by compromise.”[1. 23 F.2d 665 (2d Cir. 1928).] In approving the functional exhaustion of the underlying limits through settlement with the underlying insurer, the court reasoned that the excess insurer “had no rational interest in whether the insured collected the full amount of the primary policies, so long as it was only called upon to pay such portion of the loss as was in excess of the limits of those policies” and that “[t]o require an absolute collection of the primary insurance to its full limit would in many, if not most, cases involve delay, promote litigation, and prevent an adjustment of disputes which is both convenient and commendable.”[2. *Id.*] To counter the functional exhaustion approach, excess insurers began adding language to their policies to specify and limit how the underlying limits could be exhausted. Today, it is not uncommon for excess policies to explicitly require the underlying limits to be exhausted through “actual payment” or “payment in legal currency.” And some policies go so far as to require that the underlying limits be paid by the underlying insurer rather than the insured. A number of courts have enforced those exhaustion limitations, finding the specific language of the excess policies trumps the public policy rationale articulated in *Zeig.* [3. *See, e.g., Quellos Group LLC v. Fed. Ins. Co.,* 312 P.3d 734 (Wash. Ct. App. 2013); *Forest Labs., Inc. v. Arch Ins. Co.,* 38 Misc.3d 260, 953 N.Y.S.2d 460 (N.Y. Sup. Ct. 2012); *Intel Corp. v. Am. Guarantee & Liab. Ins. Co.,* 51 A.3d 442 (Del. 2012); *Citigroup, Inc. v. Fed. Ins. Co.,* 649 F.3d 367 (5th Cir. 2011).] The effect can be severe. A policyholder that settles with its underlying insurer for less than the underlying limits, believing it can simply pay or be liable for the resulting gap and then access its excess coverage, may instead be denied any excess coverage because the underlying limits were not exhausted in accordance with the precise terms of the excess policy. Last summer, *Zeig* suffered another apparent blow when the Second Circuit suggested the policy rationale it had articulated in *Zeig*, which involved an excess property policy, may not apply with equal force to excess liability coverage. In *Ali v. Fed. Ins. Co.,[4. 719 F.3d 83 (2d Cir. 2013).]* the court held that, in the context of the excess liability policies at issue, exhaustion provisions requiring the underlying limits to exhaust by “payment” of losses or claims required actual monetary payment of the underlying limits. In distinguishing *Zeig,* the Court stated: [N]othing is inherently errant or unusual about interpreting an exhaustion clause in an excess *liability* insurance policy differently than a similarly written clause in a first-party *property* insurance policy. … * * * * [The excess liability insurers] have a clear, bargained-for interest in ensuring that the underlying policies are exhausted by actual payment. If the [insureds] were able to trigger the Excess Policies simply by virtue of their aggregated [but unpaid] losses, they might be tempted to structure inflated settlements with their adversaries in the [underlying] litigation that would have the same effect as requiring the Excess Insurers to drop down and assume coverage in place of the insolvent carriers.[5. *Id.* at 93-94.] Notably, *Ali* did not address a settlement between a policyholder and its underlying insurer, and the court noted it was not deciding whether an excess insurer had any legitimate interest in requiring that the underlying limits be paid by the underlying insurer rather than the policyholder.[6. *Id.* at 91-92.] Still, excess insurers are likely to ignore that distinction and argue that *Ali* marks the death knell of *Zeig* in the context of excess liability insurance. And unfortunately for policyholders, using exhaustion provisions to prohibit a policyholder from settling with its underlying insurer may be only the tip of the iceberg. In past few years a number of cases have addressed arguments by an excess insurer that its

coverage layer did not attach because the underlying limits, although paid, were not "properly" exhausted. In those cases, the excess insurer asserted that the underlying insurer had improperly paid settlements or defense expenses it should not have paid according to terms of the underlying policy, or had paid claims that, although covered by the underlying policy, did not count towards exhaustion according to the terms of the excess policy.[7. *See, e.g., Royal Indem. Co. v. C.H. Robinson Worldwide, Inc.*, No. A 08-0996, 2009 WL 2149637 (Minn. App. July 21, 2009); *see also Viking Pump, Inc. v. Century Indem. Co.,* C.A. No. 10(c-06-141 FSS CCLD N10C-06-141 (Del. Super., Oct. 31, 2013) (ultimately finding underlying insurer's payments were proper); *H.B. Fuller Co. v. United States Fire Ins. Co.,* Nos. 14-132, 14-1134, (8th Cir. 2014) (currently on appeal).] Allowing such after-the-fact challenges to payments made by the underlying insurer obviously poses problems for policyholders. Theoretically, if an excess insurer can retroactively challenge payments made by an underlying insurer, then for each defense and settlement decision made in the underlying action, the policyholder (and its defense counsel) will not only need to get approval from the insurer then on the risk, but will also need to determine whether the payment could be subject to a latter challenge by an excess insurer higher up in the coverage tower. And even if the underlying payments are ultimately found to have been proper, the insured may have to incur the expense and burden of having to prove the propriety of those payments in a coverage dispute with its excess insurer. **A Victory for Policyholders** In June, the Fifth Circuit issued an opinion that provides a victory for policyholders. In *Indemnity Ins. Co. of North America v. W&T Offshore, Inc.,*[8. No. 13-20512, --- F.3d ---, 2014 WL 2853586 (5th Cir. June 23, 2014), *review denied.*] the policyholder sought excess coverage for certain expenses it incurred in the wake of Hurricane Ike. Even though the expenses at issue were a type that was covered by the policyholder's umbrella/excess policies, those insurers denied coverage. The umbrella/excess insurers argued that the underlying "retained limit" was not exhausted because the underlying insurers had paid first-party property claims that, although covered by those underlying policies, were not covered by the umbrella/excess policies. They relied on a policy provision stating: If the applicable limits of the [underlying policies] … are reduced or exhausted *by payment of one or more claims that would be insured by our Policy* we will: 1. In the event of reduction, pay in excess of the reduced underlying limits of insurance; or 2. In the event of exhaustion of the underlying limits of insurance, continue in force as underlying insurance.[9. *Id.*at *2 (emphasis added).] In rejecting that argument, the Fifth Circuit first examined the polices' coverage provisions, which required the umbrella/excess insurers to pay "those sums in excess of the Retained limit that the Insured becomes legally obligated to pay." [10. *Id.* at *4.] The Court noted that "nothing in the text of the coverage provision or the definition of Retained limits specifies how the $161 million 'limit[] of the underlying policies' mush be reached or state that the Retained Limit refers exclusively to sums covered by the Umbrella Policy." The Court read the provision relied on by the umbrella/excess insurers as applying only to the scenario in which the umbrella/excess insurers were obligated to continue in force as underlying insurance, and not as a condition on their general obligation to pay sums in excess of the underlying Retained limit. Viewing the policy has a whole, the Court held the umbrella/excess insurers' were obligated to pay sums in excess of those underlying limits regardless of how they had been exhausted.[11. *Id.*at *4-5.] *W&T Offshore* offers a reasoned examination of the types of seemingly conflicting provisions often found in excess policies and rejected an insurers' expansive reading of a single restrictive provision to try to avoid coverage. However, the Fifth

Circuit's finding of coverage was based on the particular language of the policies at issue in that case. Given the lack of uniformity or standardized language among excess policies, the decision may have limited impact in a case involving different policy language. **Take Away** So what is a policyholder to do? First, don't panic. Keep in mind that the outcome of any claim for excess coverage will depend on the particular facts of the case and the specific language of the policies at issue. Still, to avoid having to address these issues in a coverage dispute, policyholders would be wise to view the words "follow form" in the title of their excess policies with a skeptical eye. When purchasing insurance, policyholders and their brokers or experienced coverage counsel should review the policies at every level of coverage to determine how each policy may differ from the policies beneath it and what restrictions the excess policies may purport impose on the exhaustion of the underlying limits. Policyholders should ask their excess insurers to remove any language that may seem to place unacceptable conditions or restrictions on how the underlying limits can be exhausted. It is also generally a good idea for policyholders to put their excess carriers on notice of claims immediately and to keep them apprised of substantive defense decisions and settlement discussions even while still operating within the underlying limits. After-the-fact disputes over payments made by the underlying insurers or settlements between the policyholder and the underlying insurers may be avoided if all levels of a coverage tower are kept informed. Given the recent successes excess insurers have achieved in some courts, their efforts to try to influence the underlying insurance over which they sit are unlikely to go away any time soon. But with proper diligence, policyholders can still obtain consistent coverage throughout their coverage tower and keep their excess insurers in line.