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Settlement Means Policyholders Will Have To Wait For Clarification Of Proper Exhaustion Issue

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Christopher L. Lynch
Partner

It looks like policyholders will have to wait for any further answers to the question of whether and when a policyholder must show "proper" exhaustion of underlying policy limits in order to access its excess coverage. That question was teed up for consideration by the Eighth Circuit Court of Appeals in *H.B. Fuller Company v. United States Fire Insurance Company.* But in a letter filed with the 8th Circuit last week, the parties informed the court that they had agreed to settle the case, pending execution of the settlement by all of the parties. According to that letter, once the settlement agreement is signed, the parties will dismiss their respective appeals. The settlement means the 8th Circuit won't address whether, and under what circumstances, an excess insurer can challenge whether the sums paid by the underlying insurer to exhaust its policy limits were properly paid in accordance with the terms of the underlying policy. The lack of additional judicial guidance on "proper" exhaustion means policyholders and their insurers will continue to operate under a largely undeveloped body of case law regarding that issue.

Do Excess Policies Require "Proper" Exhaustion of Underlying Limits? As a general rule, excess coverage only attaches when a specified amount of underlying limits has been paid out – *i.e.,* exhausted. Thus, an excess insurer that can establish that the applicable underlying limits were not exhausted may avoid any coverage obligations whatsoever. In previous postings on the BT Policyholder Protection Blog, we've noted that excess insurers have become increasingly aggressive in trying to avoid coverage by challenging the exhaustion of the underlying policy limits. However, most of the case law on exhaustion has focused on whether the underlying limits were paid in accordance with excess policy provisions purporting to restrict who had to pay the limits (the insured or the underlying insurer) or whether the limits could be functionally "paid" via a settlement with the underlying insurer. The issue of "proper" exhaustion is a twist on the typical exhaustion challenges. When an excess insurer challenges the propriety of exhaustion, there is usually no dispute that the underlying insurer has, in fact, actually paid out its policy limits. Rather, the excess insurer is disputing that the sums paid by the underlying insurer were paid in accordance with the terms of the *underlying* policy. In other words, the excess insurer is asserting a right to effectively second guess the propriety of payment and coverage decisions made by the underlying insurer under its policy. Nationally, few courts have addressed challenges to the "propriety" of the exhaustion in this context. Three of the opinions that do discuss that question have been issued by Minnesota courts. In an unpublished opinion in *Royal Indemnity Ins Co. v. C.H. Robinson Worldwide, Inc.,*[1] the Minnesota Court of Appeals allowed an excess insurer to challenge the reasonableness

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of defense expenses and other payments made by the underlying insurer. The court relied on language in the excess policy stating: "[i]n the event ... of the ... exhaustion of the Underlying Limit by reason of the insurers of the Underlying Policies paying in legal currency *Loss*, this policy shall ... continue in force as primary insurance."[2] (Emphasis added.) The underlying policy defined "Loss" as including "Defense Costs," which were defined as "*reasonable* costs, charges and expenses … incurred in defending or investigating any claim."[3] (Emphasis added.) Under this language, the court determined it was not enough for the policyholder to show that the underlying insurer had paid out its full policy limits. Rather, the policyholder had to show that the underlying insurer's payments fit within the underlying policy's definition of "Loss," including the requirement that any defense expenses be "reasonable."[4] In *American Insurance Company v. St. Jude Medical, Inc.,* ***[5]*** the United States District Court for the District of Minnesota declined an excess insurer's request to inquire into the propriety of the underlying insurers' payments. The court distinguished the policy at issue from the one at issue in *Royal Indemnity,* reasoning:

> The [excess] Policy states that [the excess insurer's] duty to indemnify attaches to [the insured's] ultimate net loss "only after all Underlying Insurance has been exhausted by payments of the limits of such insurance." … Unlike the policy in *Royal Indemnity,* nothing in the [excess] Policy ties exhaustion to the payment of defined loss.[6]

Based on the policy language before it, the court determined that, to establish exhaustion, the insured needed to show only that the underlying insurers had paid sums equal to the limits of their respective policies.[7] In *H.B. Fuller Co. v. United States Fire Ins.* ***[8]*** *Co.,* the United States District Court for the District of Minnesota was again asked to decide an excess insurer's challenge to the propriety of an underlying insurer's payments. In an unpublished order on motions for summary judgment, the court determined that, for the excess policy to attach, the underlying limits had to be exhausted through payments that satisfied the terms of the underlying policy. Although the court noted that the attachment language of the excess policy at issue was similar to the language at issue in *American Insurance,* the court also cited a number of provisions in the excess policy that referenced the underlying policy (albeit none that limited exhaustion to payment of a defined "loss"). The court determined that, when read together, these provisions sufficiently incorporated the terms of the underlying policy so as to require a showing that the underlying limits were paid out in compliance with the terms and conditions of the underlying policy.[9] Each of these cases recognized that the factors required to establish exhaustion must be determined by the terms of the insurance contracts at issue. But collectively they provide little clarification as to exactly what policy terms might permit an excess insurer to challenge the propriety of payments made by an underlying insurer. And it now appears there will be no further clarification of that issue coming from the 8th Circuit. **How Can Policyholders Avoid a "Proper" Exhaustion Fight?** For policyholders, the possibility that an excess insurer might mount an after-the-fact challenge to payments already agreed to and made by an underlying insurer is troubling. It removes the certainty and finality that otherwise comes from receiving a favorable coverage determination, or at least obtaining defense or indemnity payments, from an underlying insurer. And giving an excess carrier the right to second guess and fly-speck payments made by an underlying insurer may force the policyholder to go through the expensive

and time-consuming process of trying justify an underlying insurer's payments well after those payments were made. To avoid the possibility of a "proper" exhaustion fight, policyholders can take steps to try to protect themselves during both the policy placement process and after a claim comes in. Given the still-developing case law, it will be difficult to identify all policy language that that might ultimately be found to permit an excess insurer to challenge the propriety of an underlying insurer's payments. However, as with other types of exhaustion restrictions, during the policy placement process, policyholders and their brokers or coverage counsel should look for and try remove any language in the excess policy that appears to place an undue restriction on how the underlying limits must be exhausted. After a claim comes in, policyholders would generally be wise to keep their excess insurers informed of the progress of the defense and settlement of the underlying claims; even while those claims are still being defended by an underlying insurer. While providing such information may not prevent an excess insurer from objecting to the coverage or payment decisions of an underlying insurer, it may get that excess insurer to voice its concerns sooner, at a time when the issue might be resolved short of a full-blown coverage dispute. Even if the issue cannot be resolved, the policyholder will be able to prepare for an eventual challenge to the propriety of the underlying insurer's payments at a time when information relating to those payments is still fresh and available.

[1] 2009 WL 2149637 (Minn. App. July 21, 2009). [2] *Id.*, at *2. [3] *Id.,* at *3. [4] *Id.,* at *2-3. [5] 2010 WL 3733009 (Sept. 20, 2010). [6] *Id.,* at *7. [7] *Id.* [8] No. 09-2827 (JRT/JJG) (D. Minn., March 2, 2012 (slip opinion). [9] *Id.* at 13-19. Notably, the facts in *H.B. Fuller* were somewhat different from those in *Royal Indemnity* and *American Insurance Company. H.B. Fuller* involved an excess carrier's challenge to payments the underlying insurer had made following a compromise agreement between the insured and the underlying insurer as to how H.B. Fuller could satisfy the per-occurrence SIR of the underlying policy. Arguably, by entering into that compromise agreement, the underlying insurer itself had recognized, at least implicitly, that the SIR may not have been satisfied in accordance with the terms of its policy, yet nevertheless chose to pay out its policy limits. Additionally, in *H.B Fuller* the district court ultimately ruled in favor of H.B. on the question of what constituted an "occurrence" under the underlying policy.