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The Return of Upstairs Downstairs In Catastrophic Loss Cases:
New cases and recent trends impacting primary and excess coverage

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I. RECENTLY ADOPTED ALLOCATION FORMULAS

A. **Straight Pro Rata Method -** allocates liability among all triggered periods

- Seminal Case: *Insurance Co. of N. Am. v. Forty-Eight Insulations, Inc.*, 633 F.2d 1212 (6th Cir. 1980)
- Recent Interpretation: *Crossmann Cmtys. of N.C. v. Harleysville Mut. Ins. Co.*, 395 S.C. 40, 717 S.E.2d 589 (S.C. 2011)
  - Facts: Coverage action arose from underlying construction defect claims involving negligent construction of condominiums resulting in water penetration and progressive damage to condominium units.
  - Held: South Carolina Supreme Court adopted "time on the risk" approach in progressive construction defect damage case. Court found this approach best harmonized policy language limiting coverage to "**policy period**" and lends itself to a logical formula that is easily applied where the actual quantum of damage incurred in each policy period is not known.

B. **Weighted Pro Rata Method** - allocates based on years and limits

- Seminal Case: *Owens-Illinois, Inc. v. United Ins. Co., 138 N.J. 437, 650 A.2d 974 (1994)*; *Carter-Wallace, Inc. v. Admiral Ins. Co.*, 154 N.J. 312, 712 A.2d 1116 (1998)
- Recent Interpretation: *Farmers Mut. Fire Ins. Co. of Salem v. N.J. Property-Liability Ins. Guar. Assn.*, 2011 N.J. Super. Unpub. Lexis 1838 (App. Div. 2011)
  - Facts: Insurer sought to recover from state fund cleanup costs expended to remediate contamination on behalf of insolvent insurer. The question was whether the policy behind PLIGA required exhaustion of all solvent insurers before PLIGA was implicated.
  - Held: New Jersey appellate division ruled that "in an environmental contamination case, the exhaustion requirement requires any solvent insurer on the risk to cover the liability until its limits have been

exhausted. Only then is PLIGA required to disburse statutory benefits to protect the insured."

C. All Sums Method - policyholder selects one triggered policy period

- Seminal Case: *Keene Corp. v. Ins. Co. of N. Am.*, 667 F.2d 1034 (D.C. Cir. 1981)
- Recent Interpretation: *Pennsylvania Gen. Ins. Co. v. Park-Ohio Indus.*, 126 Ohio St. 3d 98 (Ohio Sup. Ct. 2010)
  - Facts: Targeted insurer sought contribution from non-targeted insurers with respect to settlement of underlying bodily injury suit.
  - Held: When targeted insurer requests copies of other applicable policies, policyholder has a duty to cooperate by identifying those policies; and targeted insurer's lack of notice will only bar contribution claim if it results in prejudice to non-targeted insurer.

II. NUMBER OF OCCURENCES

A. Majority Rule - the "Cause" Test

- Focuses on number of precipitating events resulting in damage or injury
- Supported by use and definition of "occurrence" to mean "*series of related acts*" or "*continuous or repeated exposure to conditions*."
- Generally results in finding fewer occurrences than "effects" test, often resulting in less available policy limits, but also fewer deductibles.
- "The prevailing view looks to the 'cause' or 'causes' of the damage to determine the number of occurrences." *Donegal Mut. Ins. Co. v. Bamhammers*, 595 Pa. 147, 938 A.2d 286 (Pa. 2007); *see also Nicor, Inc. v. Associated Elec. & Gas Ins. Svcs. Ltd.*, 223 Ill. 2d 407, 307 Ill. Dec. 626 (Ill. 2006) ("A majority of jurisdictions have adopted the cause theory to determine the number of occurrences").

B. Minority Rule - the "Effects" Test

- Focuses on each individual injury or damage
- Generally holds that "where several injuries *result from a single underlying cause*, each injury to person or property is a *separate occurrence*"
- Tends to yield more occurrences that cause approach, which can result in greater policy limits, but also more deductibles
- *Nationwide Ins. Co. v. Central Missouri Elec. Coop., Inc.*, 278 F.3d 742 (8th Cir. 2001) - Eighth Circuit decided under Missouri law that policies in question were triggered by each occurrence of damage, not by negligent acts, but recognized a Missouri court may apply a simplified "cause" analysis for other purposes, such as determining policy limits or applying deductibles.

C. Alternative Rule (NY/CT) - the "Unfortunate Events" Test

- Focuses on temporal and special relationship between incidents giving rise to loss
- *International Flavors & Fragrances, Inc. v. Royal Ins. Co. of Am.*, 46 A.D.3d 224, 844 N.Y.S.2d 257 (N.Y. 1st Dept. 2007) - finding multiple occurrences where toxic exposure took place over several years and resulted from various batches of toxic substance.

III. STIPULATED EXHAUSTION AGREEMENTS:

Key Issue: Whether excess insurer is obligated to provide coverage to insured policyholder when primary insurer has settled with insured for less than its policy limits

A. Trends and Considerations

- Answer depends on jurisdiction
- Policy language is critical
  - Favors excess insurer: If excess policy language explicitly requires "exhaustion" or requires that the full amount of underlying coverage be paid, first, that may
  - Favors policyholder: If excess policy language states that loss is payable when the underlying insurer is no longer "obligated to pay"
- Possible public policy considerations
  - Public policy surrounding lower premiums that are charged for excess coverage may justify requiring exhaustion
  - Excess insurer's failure to defend may favor policyholder's right to excess coverage
  - Size of settlement as compared to total limits
- Direct action statutes may help support policyholder's claim for coverage

B. Policyholder Prevails - Excess Insurer Obligated to Provide Coverage Following Insured's Below-Limits Settlement With Primary Insurer

- Seminal Case: *Zeig v. Mass. Bonding & Ins. Co.*, 23 F.3d 665, 666 (2d Cir. 1928).[1] Excess carrier was obligated to provide coverage following settlement with primary burglary insurance policies for less than the limits. Court found that requiring exhaustion of the full amount would be "unnecessarily stringent," and "would involve delay, promote litigation, and prevent an adjustment of disputes which is both convenient and commendable."
  - Policy Language and Rationale: Policy stated that it "shall apply and cover only after all other insurance herein referred to shall have been exhausted in the payment of claims to the full amount of the expressed limits of such other insurance." Court found an ambiguity in the policy language,

[1] *But see JPMorgan Chase & Co. v Indian Harbor Ins. Co.*, 31 Misc. 3d 1240A, 930 N.Y.S.2d 175 (Sup. Ct. NY 2011), where insurer prevailed because Court did not follow *Zeig*, but instead looked to an Illinois federal case.

finding that the word "*payment*" "often is used as meaning the satisfaction of a claim by compromise, or in other ways."

- Recent Cases:
  - *Cincinnati Insurance Co. v. Franck*, 644 N.W.2d 471, 476 (Min. Ct. App. 2002). Injured party in automobile accident entitled to access coverage under a personal umbrella (and excess) policy after settling with insured and the primary insurer for less than the primary policy limits where the injured party agreed to absorb the gap between the settlement amount and the primary policy limits.
    - Policy Language and Rationale: Umbrella policy provided that payments would be made only "over and above the amounts provided for in the basic policies."
  - *Schmitz v. Great Am. Assur. Co.*, 337 S.W.3d 700, 706 706 n.6 (Mo. 2011).[2] In wrongful death claim where underlying plaintiffs had entered into an agreement with the primary insurer to collect only $700,000 out of a $1 million policy on a judgment, the Court held that the excess insurer was bound as well to cover the judgment. The excess policy did not require exhaustion for its obligation to pay to be triggered where it had unjustifiably refused to defend, even if that refusal was due to an "honest mistake."
    - Policy Language and Rationale: Provision concerning "[w]hen 'Loss' is Payable," is significant because the policy has "obligated to pay" language, which is different from "has already paid" language, and there were no provisions that required that the underlying insurance be "exhausted," as follows:
      - "Coverage under this policy will not apply unless and until the Insured or the Insured's 'underlying insurance' *is obligated to pay* the full amount of the 'Underlying Limits of Insurance.'"
      - "When the amount of 'loss' has finally been determined, we *will promptly pay* on behalf of the insured the amount of 'loss' falling within the terms of the policy." (italics added)

C. Insurer Prevails - Excess Insurer Not Obligated to Provide Coverage (or "Drop Down") Following Insured's Below-Limits Settlement with Primary Insurer

- Seminal Case: *Qualcomm, Inc. v. Certain Underwriters at Lloyd's, London*, 161 Cal. App. 4th 184, 73 Cal. Rptr. 3d 770 (Cal. 4th Dist. 2008).[3] Insured settled with primary insurer for coverage of D&O case in an amount less than the primary policy's limits. The Court held that the excess insurer's liability to cover policyholder's settlement does not attach until after exhaustion of the full amount of primary coverage (even if the policyholder absorbs the resulting gap between the settlement amount and the primary policy limit) if there are clear condition precedent terms in the excess policy. This holds true even if a term has been

[2] *See also Trinity Homes LLC v. Ohio Cas. Ins. Co.*, 629 F.3d 653, 658-59 (7th Cir. 2010).

[3] *See also Comerica Inc. v. Zurich American Ins. Co.*, 498 F. Supp. 2d 1019 (E.D. Mich. 2007).

judicially construed so long as it is not ambiguous ***and*** where there are no compelling equitable considerations.

  - Policy Language and Rationale: Policy was a follow form policy, and contained a "Limit of Liability" section (that stated: "Underwriters shall be liable only after the insurers under each of the Underlying Policies … have paid or have been held liable to pay the full amount of the Underlying Limit of Liability." [but Court did not determine whether "held liable to pay" might have more than one meaning]. Court looked at "drop down" cases where the primary was insolvent, and it held that California law shields the position of an excess carrier which is a "reimbursement" policy only, when the obligations are set forth in "clear phrases."

- Recent Case: *Citigroup Inc. v. Fed. Ins. Co.*, 649 F.3d 367, 371-73 (5th Cir. 2011). Citigroup sought coverage after acquiring a consumer lender who was subject to claims for a statewide consumer fraud class action and FTC claim for violating truth in lending requirements. After settling with $50 million primary layer for $15 million, Citigroup sought to recover from excess insurers. Court did not need to determine whether Texas courts would adopt the *Zeig* rule because the policies were unambiguous and required exhaustion of the primary layer before they were obligated to provide coverage.
  - Policy Language and Rationale: (1) "(a) all Underlying Insurance carriers have paid in cash *the full amount* of their respective liabilities … all Underlying Insurance has been *exhausted*."; (2) "coverage does not attach until the underlying policy's "total" limit of liability has been paid "in legal currency."; (3) "coverage attaches 'only after any Insurer subscribing to any Underlying Policy shall have agreed to pay or have been held liable to pay the full amount of its respective limits of liability as set forth" later in the policy, which "states that the 'limit of liability' for the underlying insurer is '$50,000,000.'"; (4) "coverage attaches '[i]n the event of the exhaustion of *all of the limit(s) of liability* of such Underlying Insurance solely as a result of *payment of loss* thereunder.'" [determining that "payment of loss" means "*actual payment*"].

IV. GOOD FAITH DUTIES FROM PRIMARY TO EXCESS

A. Public Policy and Other Considerations

- Varies with jurisdiction
- Protecting excess insurer from primary insurer's failure to settle, resulting in liability, or greater liability, to excess
- Favoring an excess insurer's right to enforce a primary insurer's duties to the insured and promoting fair and reasonable settlements
- Protecting excess insurer because the primary insurer is in a "knowledge" position with access to information about the negotiation and litigation of the claims.

- Protecting excess insurer from losing the policy-limit contributions of the primary insurer, and thus thwarting the different kinds of coverage and their rating structures

B. **Minority of Jurisdictions: Direct Duty of Good Faith.** The primary insurer *directly* owes the excess insurer the same good faith duty of due care it owes the insured in defending and settling a claim within the primary policy limits.
   - Seminal Cases:
     - *Continental Casualty Co. v. Pullman, Comley, Bradley & Reeves*, 929 F.2d 103, 106 (2d Cir. 1991). Court explained that New York and Michigan provide for direct duty of good faith.
     - *American Centennial Ins. Co. v. Warner-Lambert Co.*, 681 A.2d 1241, 1247 (N.J. Super. Ct. 1995). In NJ, fairness and policy require the imposition of a duty of good faith to excess carrier on the primary carrier.
   - Recent Case: *Allied World Assur. Co. (U.S.) v. Lincoln Gen. Ins*, Misc. No. 1:11-mc-00343, 2012 U.S. Dist. LEXIS 12883 (M.D. Pa. Feb. 2, 2012). Court granted motion to enforce a subpoena for files against the non-party primary insurer in bad faith claim brought against excess insurer for failing to settle the underlying personal injury claim following automobile accident. "[I]n Florida, a primary carrier owes a duty of good faith to an excess carrier - the same duty it owes to its insured." (citing *Progressive Am. Ins. Co. v. Nationwide Ins. Co.*, 949 So.2d 293, 294 (Fla. Dist. Ct. app. 2007).[4]

C. **Majority of Jurisdictions**: **No Direct Duty of Good Faith.**

   1. **Equitable subrogation to the rights of the insured**.
      - Seminal Cases:[5]
        - *Continental Casualty Co. v. Reserve Insurance Co.*, 238 N.W.2d 862, 864-65 (Minn. 1976). "[A]n 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." The primary insurer has the duty to use the "utmost good faith" in handling, evaluating, defending and settling claims made against its insured.
        - *Great Southwest Fire Ins. Co. v. CNA Ins. Cos.*, 557 So. 2d 966, 969, 971 (La. 1990). "[T]the primary insurer does not owe a duty of care or even a good faith performance to the excess insurer of its insured." But, the primary insurer "should be held liable for reimbursement of the whole debt to [the excess insurer] because the primary's bad faith failure to perform caused the excess judgment and … it should be considered the principal obligor."
      - Recent Case: *Reliance Ins. Co. v. Chitwood*, 433 F.3d 660, 664-65 (8th Cir. 2006). Court rejected excess insurer's attempt to recover from insured and primary insurer for the amount that it separately paid to settle the matter

[4] *See also New Eng. Ins. Co. v. Healthcare Underwriters Mut. Ins. Co.*, 352 F.3d 599, 607 (2d Cir. 2003).
[5] *See also Greater N.Y. Mut. Ins. Co. v. North River Ins. Co.*, 85 F.3d 1088 (3d Cir. 1996).

arising from an automobile accident. Court found that primary carrier had "protected" insurer by settling for below-policy limits on terms where excess would not be obligated unless a judgment exceeded the policy limits. "Missouri courts … have not recognized a direct duty of good faith between primary and secondary insurers. The Court did not adopt the "modern trend trend for courts and legislatures to impose duties of good faith and fair dealing on the relationship between primary and excess carriers."

2. <u>Limited Equitable Subrogation</u>

- <u>Recent Case</u>: *Fed. Ins. Co. v. Travelers Cas. & Sur. Co*., 843 So. 2d 140 (Ala. 2002).
    - <u>Facts:</u> Judgment entered on a $4.5 million jury verdict in wrongful-death action against a construction company where there was evidence that case could have been settled before trial for $350,000. Before appeal completed, case settled for $4.6 million and $1 million paid by primary and $3.6 million paid by excess.
    - <u>Held:</u> Primary does not owe excess carrier any duty of good faith. And equitable subrogation for a bad-faith-failure-to-settle claim does not exist where the insured is "never subject to a final judgment" and where the insured is subject to no personal loss.