Second Circuit confirms excess insurance is triggered only upon actual payment of all underlying limits

Insurance Alert

6 JUN 2013

By: Joseph G. Finnerty III

This week Federal Insurance Company achieved an important victory in a long-standing insurance coverage litigation concerning the proper trigger of excess directors and officers insurance. DLA Piper represented Federal, a division of Chubb & Son, in the case.

In a much-anticipated decision on June 4, the United States Court of Appeals for the Second Circuit confirmed the position advanced by Federal, holding that Federal's excess directors and officers liability insurance policies issued to the former executives of long-defunct Commodore International Limited (maker of the classic Commodore 64 personal computer) cannot be triggered absent actual payment of the limits of liability of all underlying insurance.

The Second Circuit opinion, *Medhi Ali, et al. v. Federal Insurance Company*, authored by Judge José A. Cabranes, affirms a precedent-setting decision by District Court Judge Richard J. Sullivan, *Federal Insurance Company v. The Estate of Irving Gould, et al.*, in the Southern District of New York. The Second Circuit held that Federal and Travelers (another excess insurer on the tower) have no obligation under their excess policies until the amount of the underlying insurance limits is paid, even if unpaid exposure in the underlying case or an unpaid settlement reaches the excess insurance layers.

The litigation arose in the wake of lawsuits commenced as a result of Commodore's bankruptcy in the 1990s. Commodore's former directors successfully defended or settled all but one action pending in the Bahamas. In connection with the defense and settlement of the Bahamian Court claims, the directors and officers turned to Commodore's D&O insurers and ultimately exhausted the primary layer.

Critically, Reliance Insurance Company and The Home Insurance Company of Indiana, which underwrote the first, third, fourth and sixth layers of Commodore's insurance tower, were insolvent, and their limits of liability never would be paid by those insurers. Language in the excess policies dictated that their coverage would be triggered only after all underlying insurance limits had been "exhausted by payment of claims," but the directors and officers asked the District Court to declare that the excess policies would be triggered in the event the directors and officers were obligated to pay a loss that reached the excess layers – even if that loss is never paid by either the insurers or the insureds. The District Court ruled that the excess policies required "exhaustion" of the limits by payment, and the directors and officers appealed.

The Second Circuit on Tuesday affirmed the District Court decision and held that the excess directors and officers liability insurance policies issued to Commodore could not be triggered unless and until the limits of all underlying insurance were in fact paid – even if the directors' and officers' liability exposure or obligation in a settlement or judgment might reach the excess insurance layers. In reaching this decision, the Second Circuit held that "the very nature of excess insurance coverage is such that a predetermined amount of underlying primary coverage must be paid before the excess coverage is activated," and confirmed that the plain language of the Federal and Travelers excess policies in fact required "payment of claims." Importantly, the Second Circuit **rejected the directors' and officers' argument that having an unpaid obligation or liability exposure was the equivalent of a payment sufficient to trigger excess coverage**, holding that "'obligations' are not synonymous with 'payments' on those obligations."

Prior to this ruling, the Second Circuit's 1928 decision in *Zeig v. Massachusetts Bonding & Ins. Co.,* 23 F.2d 665 (2d Cir. 1928), had been the centerpiece of countless arguments by policyholders that, even when an excess policy requires exhaustion of underlying limits before it is triggered, the insured can nevertheless still trigger its excess policy without any party paying the full amount of the underlying insurance limits.

In Tuesday's decision, the Second Circuit addressed, for the first time, the fundamental limitations of its 85-year-old decision in *Zeig*, holding that ***Zeig* was not useful or applicable precedent** in the pending case for two reasons that will resonate effectively for insurers in analogous liability insurance coverage disputes.

First, the Court held that its earlier decision in *Zeig* was distinguishable for the critical reason that Judge Augustus Hand was evaluating a first-party property insurance policy, and not a liability insurance policy. The Second Circuit helpfully explained that it is quite reasonable to interpret an exhaustion clause in an excess liability insurance policy differently from an exhaustion clause in a first-party property insurance policy, even if the language of the two clauses are comparable.

Second, *Zeig* and other similar cases address an insured's settlement of indemnity claims with its underlying carrier for less than the full limits of the lower-level policy where the insured has in fact suffered out-of-pocket losses. Here, by contrast, the directors and officers sought insurance coverage for an inchoate and negotiable obligation to pay third parties in the remaining Bahamian action. The Second Circuit recognized that, in these circumstances, the excess insurers had good reason to enforce the plain language of their excess policies and require actual payment of underlying layers in order to deter "the possibility of settlement manipulation."

In short, the Second Circuit affirmed the central principle that an excess insurer has no obligation to pay absent actual "payment" of money equal to the limits of liability in the underlying insurance policies. **The Second Circuit's decision effectively circumscribes the applicability of its own earlier holding in *Zeig*,** and the case no longer may be properly cited to support the principle that simple exposure to liability, or an obligation to pay, in amount that can be quantified to be excess of the limits of underlying liability insurance is enough to trigger excess coverage.

A key lesson from this important decision is that **excess directors and officers insurance policies are not designed to protect an insured against the risk of either non-payment of claims by, or the insolvency of, the underlying insurers**. Policyholders can protect themselves against these risks by purchasing what is called "Side A" insurance policies that are designed to address the very situation faced by Commodore's former directors and officers.

Commodore, in fact, had purchased precisely such protection in the form of a separate "umbrella" policy that was not conditioned on exhaustion of underlying insurance and was specifically intended to "drop down" in the event any other insurance was not "collectible." Unfortunately, for the Commodore directors and officers, Commodore did not purchase sufficient Side A or umbrella coverage, leaving them to argue that Commodore's other excess insurers should provide coverage even in the absence of actual payment of the underlying limits – an argument that has now been resoundingly rejected by the Second Circuit.

To learn more about the impact of this decision on your business, please contact:

Joseph G. Finnerty III
Rachel V. Stevens
Eric S. Connuck

FROM THE ARCHIVE
DLA Piper's *Insurance Year-End Review and 2013 Forecast*

AUTHORS

Joseph G. Finnerty III
Partner
New York | T: +1 212 335 4500
joseph.finnerty@dlapiper.com