

Client Alert

June 2013

Second Circuit Requires Payment of Underlying Losses to Trigger Excess Coverage Based on Policy Provisions

The US Court of Appeals for the Second Circuit recently held that excess insurance policies are triggered when the payment of losses exceed the attachment point rather than when the policyholder's loss obligations exceed the attachment point. *Ali v. Fed. Ins. Co.*, No. 11-5000-cv, 2013 WL 2396046 (2d Cir. June 4, 2013). The decision is another reminder that outcomes in insurance disputes may depend on subtle differences in the wording of insurance policies. In addition, the court made clear that to trigger excess policies it is not necessary that the underlying insurer make the payment, so long as payment is made. This result will enable policyholders to resolve claims involving the underlying policies while protecting their ability to recover under excess insurance policies.

Background

Former directors and officers of Commodore International Limited (the "Directors") sought coverage under excess insurance policies issued by Federal Insurance Company and Travelers Casualty and Surety Company of America. Reliance Insurance Company and Home Insurance Company had issued coverage underlying that of Federal and Travelers. However, because Reliance and Home were no longer operating, the Directors could not collect from the policies underlying Federal's and Travelers' excess policies.

Therefore, the Directors sought a declaration that Federal's and Travelers' "coverage obligations are triggered once the total amount of [the Directors'] 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." The district court denied the Directors' motion for summary judgment and found that the Federal and Travelers policies were not triggered until there was payment of the underlying losses.

The Directors appealed.

The Second Circuit's Opinion

Relying on language in the Federal and Travelers policies, the Second Circuit affirmed¹. The Federal policies provided that the coverage "shall attach only after ... 'Underlying Insurance' has been exhausted by payment of claim(s)" and that exhaustion of the underlying insurance occurred "solely as a result of payment of losses thereunder." The Travelers policy contained similar provisions that provided that coverage "shall attach only after all such Underlying Insurance has been exhausted," and that exhaustion occurred "solely as a result of payment of losses thereunder." Because coverage under the excess policies turned on *payment* of underlying losses, the Second Circuit affirmed the district court's decision and rejected the Directors' argument that the excess policies were triggered when their *obligations* exceeded the attachment points.

¹ Because there was no conflict between New York and Pennsylvania substantive law, the Second Circuit did not determine which state's law applied.

The Second Circuit clarified that the district court did not hold that the underlying insurers must actually make the payments. Instead, the excess policies required only that there be payment of underlying losses and did not require that the underlying insurers make that payment. In fact, the Second Circuit explained that requiring Reliance and Home to make the payments before Federal's and Travelers' policies were triggered would be an "odd" result given that Reliance and Home were nonoperational and unable to make the payments and that it would effectively leave the Directors without coverage. Thus, it appears, that payment by an insured of claim amounts, or for that matter, partial payment by underlying carriers and the insured should be sufficient to trigger excess policies when the total payments equal the sum of the underlying limits.

In addition, the Second Circuit dismissed the Directors' reliance on a first-party property insurance decision, *Zeig v. Massachusetts Bonding & Insurance Co.*, 23 F.2d 665 (2d Cir. 1928). In *Zeig*, the court held that the policyholder could access its excess policy for an underlying burglary loss as long as the loss exceeded the limits of the primary policy and even if the primary policy had not paid its limits. The Second Circuit distinguished that decision, noting that in *Zeig*, the policyholder had actually suffered a loss whereas the Directors' focus was on their obligations to pay third parties. The court explained that permitting the Directors to access the excess policies only through "obligations" would allow the Directors to manipulate a settlement for an inflated amount.

Insurance Implications

The Second Circuit's decision in *Ali v. Federal Insurance* is a reminder that insurance disputes may turn on small differences in policy language. In *Ali*, the court focused on the wording of the policies at issue, which required payment of underlying losses. The Second Circuit's opinion should not apply to excess policies that do not, by their terms, require "payment of losses" to exhaust underlying policies. Significantly, the court did not require that the payment be made by the underlying insurer. Given the reasoning of the opinion, so long as the policyholder (or perhaps even another party) makes payment, that, combined with any payment by the underlying insurer, should be sufficient to trigger the excess policy. A contrary opinion would be inconsistent with the manner in which excess insurance is underwritten, with underwriters focusing primarily on the amount being paid before their policy is triggered, rather than the entity making the payment, and would ignore the realities of the need for excess insurance when settling claims.

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