"Wrongful Exhaustion" - Challenging the Payment Decisions of Underlying Insurers

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Generally, under California law, an excess policy is triggered when the underlying policy limits are exhausted through payments by the underlying insurers. Excess insurers often must analyze the underlying insurers' payments via loss runs to confirm the exhaustion of the underlying insurance policies.

Recently, some excess insurers have made claims that the underlying insurers have made improper payment decisions, which have wrongfully exhausted or eroded the underlying policy limits. Effectively, these excess insurers argued that due to such improper payments, the underlying policy limits were in fact not exhausted and that the excess insurers' policies were thus not triggered.

The United Stated Court of Appeals for the Ninth Circuit weighed in on this issue. Two cases highlight the conditions under which an excess insurer may challenge the payment decisions and coverage determinations of the underlying insurer.

Axis Reinsurance Co. v. Northrop Grumman

Prior to *AXIS Reinsurance Co. v. Northrop Grumman Corp.*, 975 F.3d 840 (9th Cir. 2020), there had been no California or Ninth Circuit case discussing an excess insurer's right to make a covered-claims challenge to the exhaustion of underlying insurance. This is despite the fact that policyholders are at times presented with this argument from excess insurers. Accordingly, this case is very helpful to both insurers and policyholders.

In *AXIS Reinsurance*, two underlying lawsuits had been filed against Northrop Grumman ("Northrop") alleging violations of the Employee Retirement Income Security Act of 1974 ("ERISA"), the first brought by the Department of Labor with regard to the Northup Savings Plan, the second brought on behalf of that Savings Plan and another Northrop savings program. Northrop settled both lawsuits and tendered the settlements to its insurers for coverage.

Northrop carried a multi-layered program of Employee Benefit Plan Fiduciary Liability Insurance, including: (1) a $15 million primary insurance policy with National Union Fire Insurance Company ("National Union"); (2) a $15 million excess insurance policy with Continental Casualty Company ("CNA"); and (3) a $15 million secondary excess insurance policy with AXIS. As a secondary excess insurer, AXIS was required to drop down to provide coverage but only after the underlying insurance policies' limits had been exhausted by payment of "covered loss" under those policies.

National Union determined that the first settlement fell within the scope of coverage of its primary insurance policy, which covered loss from actual or alleged wrongful acts by Northrop or its employees, including violations of ERISA. National Union paid a portion of the first settlement, thereby exhausting its $15 million liability limit.

CNA adopted National Union's position and thus dropped down and paid the remainder of the amount of the first settlement. CNA's partial payment, however, did not fully exhaust its $15 million liability limit. As such, AXIS was not required to cover any portion of the first settlement.

As the first settlement exhausted National Union's primary coverage, CNA paid the subsequent second settlement, after CNA determined that this second settlement fell within its scope of coverage. Accordingly, CNA contributed payment of the total settlement cost, thereby exhausting the remainder of its $15 million liability limit. At that time, AXIS was asked to pay the remainder of the second settlement. AXIS did not contest the validity of the second settlement under the terms of its excess policy, and AXIS thus covered its portion of the second settlement. Notably, the AXIS excess policy did not contain a provision for AXIS to challenge the propriety of payments by underlying insurers for "covered loss."

AXIS notified Northrop that it intended to seek reimbursement of the first settlement amount on the ground that the earlier payments by National Union and CNA were "not for covered loss" and that their payments were outside the scope of their coverage. AXIS argued that these "improper" payments by the underlying insurers as to the first settlement prematurely triggered AXIS' excess liability.

AXIS filed a complaint for declaratory relief, seeking reimbursement of the insurance payment that it made as secondary excess insurer to Northrop. AXIS argued "improper erosion," i.e., that the collective payments of the first settlement by National Union and CNA were not for covered loss and therefore improperly eroded the limits of liability of their underlying policies, which caused AXIS to drop down by the settlement amount, unjustly enriching Northrop by the same amount. AXIS argued that the first settlement payment constituted disgorgement rendering it "uninsurable under [California] law" and thus an uncovered loss under the terms of the primary and excess policies. In short, AXIS sought to reduce its liability for the second settlement by disputing the validity of the first settlement, which AXIS had not been asked to cover.

AXIS further argued that Northrop's underlying insurers paid these "uncovered" claims related to Northrop's settlement of ERISA violations, which "improperly eroded" the liability limits of their policies, thereby prematurely triggering AXIS' excess coverage. The district court agreed and granted AXIS' motion for summary

judgment. The district court held that AXIS was entitled to seek reimbursement of the payment amount from Northrop against a later, valid claim. The district court further held that AXIS' payment was not covered by its excess coverage policy and thus AXIS would be entitled to reimbursement of the settlement amount for its excess coverage. Northrop appealed.

On appeal, Northrop argued that AXIS, and not Northrop, assumed the risk that Northrop's primary and first level excess insurers might adjust claims in a manner that would trigger AXIS' secondary excess coverage. Ultimately, the Ninth Circuit reversed and held that in excess insurer claims of improper erosion, improper exhaustion, wrongful exhaustion, and similar challenges to the payment decisions of underlying insurers, an excess insurer may not challenge those decisions in order to argue that the underlying liability limits were not—or should not have been—exhausted absent a showing of fraud or bad faith, or the specific reservation of such a right in its contract with the insured.

In so ruling, the Ninth Circuit focused on the objectively reasonable expectations of the insured. The Ninth Circuit determined that no reasonable insured in Northrop's position would understand that it might have to justify its underlying insurers' payment decisions as a prerequisite to obtaining excess coverage from AXIS. Further, the Ninth Circuit indicated that excess insurers generally may not avoid or reduce their own liability by contesting payments made at underlying levels of insurance, unless there is an indication that the payments were motivated by fraud or bad faith.

Excess insurers may contract around this general rule by including specific language in their policies reserving a right to challenge prior payments, as long as the provision is not prohibited by applicable law. As an example, the Ninth Circuit offered language from *Axis Surplus Ins. Co. v. Innisfree Hotels, Inc.*, No. CIV.A. 05-0527-WS-C, 2006 WL 2882373, 2006 U.S. Dist. LEXIS 73230, at *9 n.22 (S.D. Ala. Oct. 6, 2006) (noting that "the Axis Excess Policy . . . states that amounts paid by underlying insurance for losses that would not have been payable under the Axis Excess Policy do not count towards the $10 million" liability limit and "*do not erode* the $10 million threshold . . . .") (emphasis added). Here, however, there was no indication that Northrop and AXIS mutually agreed that the "covered loss" provision in the AXIS policy would have this effect.

The Ninth Circuit also relied upon *Costco Wholesale Corp. v. Arrowood Indem. Co.*, 387 F. Supp. 3d 1165 (W.D. Wash. 2019). In *Costco*, a third-layer excess insurer contended that its policy should not have been triggered as the underlying insurers should have refused to pay some or all of the $30 million in attorney's fees and costs submitted to them in relation to an $8 million class action settlement between Costco and its employees. The third-layer excess insurer argued that its excess policy

(which contained similar language to the "covered loss" provision in the AXIS policy) required Costco to defend the underlying insurers' coverage decisions. The *Costco* court held that generally, an excess insurer may not second guess the coverage determinations of the underlying insurers, absent an indication of fraud, bad faith, or a contractual right to interfere in their adjustment processes.

The Ninth Circuit noted that allowing excess insurers to contest the soundness of underlying insurers' payment decisions "would undermine the confidence of both insureds and insurers in the dependability of settlements," thereby eliminating one of the primary incentives for obtaining insurance. *AXIS Reinsurance*, 975 F.3d at 846. Additionally, such a rule would create inefficiencies in the insurance industry, with little benefit for policyholders. Further, there is little evidence of insurance companies paying out claims (let alone their policy limits) when they are not obligated to do so.

Scottsdale Ins. Co. v. Certain Underwriters at Lloyds, London

In *Scottsdale Ins. Co. v. Certain Underwriters at Lloyds, London*, 839 F. App'x 105 (9th Cir. 2020), the insured (Dickstein Shapiro LLP) had purchased a primary policy from certain Lloyd's of London syndicates and an excess policy from Scottsdale. After one of Dickstein's partners was sued for legal malpractice, Underwriters refused to defend. Dickstein sued for coverage and for bad faith failure to defend.

Thereafter, Underwriters reached a settlement with Dickstein related to: 1) legal malpractice claims against Dickstein's former partner, and 2) Dickstein's claims against Underwriters for bad faith and failure to defend the malpractice claim. The settlement agreement did not allocate between the claims, but Underwriters allocated the $17.5 million settlement as follows:

$11.74 million from the primary policy (the remaining limit);
$ 1.26 million as "extra-contractual liability"; and
$ 4.50 million to be paid by Scottsdale.

As an excess insurer, Scottsdale challenged Underwriters' allocation and sought a determination that the settlement did not erode the limits of the primary policy. In response, Underwriters relied on *Axis Reinsurance* and argued that Scottsdale could not challenge the underlying erosion of limits. Scottsdale noted that Dickstein's bad faith failure to defend claims were against Underwriters rather than the insured, and that Scottsdale had not contractually agreed to cover those claims.

The Ninth Circuit agreed with Scottsdale, noting that the settlement agreement and allocation appeared to be a product of collusion. The primary policy required

Underwriters to pay on behalf of the Assured damages and claims which the Assured shall become legally obligated to pay because of any claim or claims, arising out of any act, error, or omission of the Assured. The Ninth Circuit indicated that anything paid by Underwriters to settle the bad faith or failure to defend claims were not part of the primary policy limits, but rather should have been considered "extra contractual liability" for Underwriters.

Key Takeaways

Absent a contractual provision, excess insurers may not contest the payments of other insurers for earlier claims unless there is evidence that those payments were motivated by fraud or bad faith. Excess insurers should carefully scrutinize settlement agreements and the allocations made by underlying insurers, and should carefully analyze whether the claim is made against the insured or the insurer and whether the claim is for a covered loss.

Excess insurers should consider adopting specific policy language reserving the right to contest "improper erosion" by the underlying insurers under certain conditions, as long as such a provision does not conflict with applicable law or public policy.