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Special Advertising Section

OUTSIDE PERSPECTIVES

Act Now to Muffle the Supposed And Extreme Exhaustion Defense In Your Excess D&O Policies

The Exhaustion Hoodwinking – A Tragedy in Two Acts

Act I – Underwriting Is Happy

YOU BUY A "SEAMLESS" MULTI-layer tower of directors and officers (D&O) liability insurance to protect your company and your directors and officers. Your top-flight insurance broker gives the OK. Each insurance company up that tower is eager to take your hard-earned premium check. You believe that you have purchased a seamless – and very expensive – tower of D&O liability insurance. Sleep well poor policyholder.

William G. Passannante
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Act II – Claims are Grumpy

A D&O liability claim comes in that may impact the primary and excess layers of insurance coverage of your expensive, seamless tower of protection. Since you weren't born yesterday, you hire able counsel. The primary insurance company urges a number of defenses to coverage, so as in any other scenario, a compromise is reached. You, poor unsuspecting policyholder, agree to settle the primary level of insurance for less than the full limits of the primary-level policy. After all, it's a compromise.

Surprise! Like an unwelcome jack-in-the-box the excess insurance company argues that settling with the primary level insurance company for $1 less than full limits eliminates all ability to trigger excess insurance, "So sorry, we never mentioned this when we sold you the policy, we have hired the law firm of Hyper & Technical, LLP and while it may be completely contrary to what we said we were selling when you paid those big insurance premiums, these Hyper & Technical lawyers have an argument which eliminates all your excess insurance because you didn't fully exhaust the primary policy, and we do need to protect our shareholders." So, your trusted excess insurance company argues that because you took $1 less than full limits from the primary insurance company to resolve their arguments, they owe you nothing. They say your excess insurance policy isn't. Apparently, it was merely a premium transfer device from you to the excess insurance company.

The End.

This tragedy might almost be amusing if it weren't true in a few courts. For policyholders, there were two troubling "exhaustion" decisions handed down recently. In one such decision, a United States District Court ruled that the policyholder (who had been sued for securities laws violations) could not tap its excess directors and officers liability insurance coverage, because the policyholder settled its insurance claim with the primary D&O insurance company for less than full policy limits. According to the court, this was fatal to a recovery of excess D&O insurance coverage: "In the court's view, the plain language of the Federal policy's insuring clause – 'the full amount of the underlying limit' – does not mean 'some lesser amount' or 'partial amount,' nor does it contemplate the insured 'filling the gap' or 'crediting the difference[.]'"

In effect, the court ruled that the policyholder had forever forfeited its right to excess insurance coverage because the policyholder had accepted less than the full policy limits from the underlying D&O insurance company. This ruling

is emblematic of a recent limited line of cases. These cases depart from the well-established decades-old majority rule (and insurance industry practice) by which a policyholder could recover excess insurance so long as it bridged the gap between the amount of money received from the underlying insurance company and the attachment point of the excess insurance company.

In some jurisdictions with some primary level insurance companies, if a policyholder receives less than its full policy limits within a layered insurance program, the policyholder may hear about "exhaustion" defenses to coverage from its excess insurance companies. Although there are many courts that follow the rule and industry practice that: (1) a policyholder may settle with an underlying insurance company; (2) bridge the gap itself for any shortfall in the claims payment by the reluctant underlying insurance company; and (3) then validly claim against the excess insurance company, the recent ruling is a sobering reminder that there is sufficient risk to the outcome in certain jurisdictions.

So what to do? Policyholders should address this issue at the source. Policyholders would be wise to direct their insurance brokers and other insurance professionals to purchase their excess insurance policies with clear terms that expressly provide that they may settle claims in the underlying layers and bridge any shortfalls without forfeiting their excess insurance protection. Moreover, there should be express language which avoids penalizing excess insurance coverage rights just because an underlying insurance company may become insolvent before a claim needs to be paid. Insurance brokers and other industry professionals can and should often secure this preferred policy language at little or no cost. The costs of leaving it up to a later dispute when the excess coverage is needed most after a claim has been made can be far greater.

Are the insurance companies making these extreme arguments behaving like reasonably trustworthy business partners? These newly concocted exhaustion arguments are extreme and contrary to decades of practice in the industry and case law. Is any extreme argument dreamt up by the insurance denial mavens at Hyper & Technical an argument that your D&O insurance company should make?

Unfortunately this specific exhaustion problem is compounded by insurance brokers and other professionals not eliminating this potential problem at underwriting time, as well as by unsuspecting lawyers and other advisors simply thinking that this extreme argument would not be made by a trusted insurance company and certainly not adopted by a court.

Be armed for these extreme "exhaustion" disputes. Avoid insurance companies that insist on making these strained "exhaustion" arguments. Avoid brokers and insurance professionals who won't fix your D&O liability insurance tower to eliminate the problem, and make sure your legal and other professionals are fully aware of the intricacies of this highly specialized insurance area. Hyper & Technical will continue to make extreme exhaustion arguments regarding your bought and paid for D&O liability insurance policies. Policyholders need to push back at underwriting time, at claims time, and if need be in court, and push back hard. Acting early can help to muffle the supposed and extreme exhaustion defense.

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