Coverage Quelled by Extreme Exhaustion Arguments

by William G. Passannante and Joshua Gold

Companies that have purchased towers of excess directors and officers insurance take warning: Washington is the latest state to hold that settling a claim with your primary D&O insurance company may negate excess coverage on grounds that the primary policy was not "exhausted."

The case, Quellos Group LLC v. Federal Insurance Company et al., should prompt directors and officers to ask: Has our broker made sure that our tower of D&O insurance is as seamless as claimed—and proof against extreme "exhaustion" arguments?

Bad Facts Can Make For Tough Results

Quellos Group was a Seattle-based investment management company. Beginning in 1999, former officers and employees developed a new tax shelter strategy called the personally optimized investment transaction, or POINT, which gave clients the opportunity to offset capital gains with losses. Admittedly, the unfavorable and unflattering factual pattern of this case was not conducive to public policy arguments in favor of policyholders generally.

The Quellos decision summarizes the POINT scheme as follows: Using circular transactions and offsetting payments that cancelled each other out, these offshore corporations created a paper portfolio of more than $9 billion in U.S. high tech stocks that appeared to suffer price drops and generated the fake capital losses used in the POINT transactions. The fees charged by Quellos depended upon the amount of tax loss generated in each transaction for the taxpayer who bought the shelter; the more money the taxpayer "lost" from the transaction, the more Quellos charged for the scheme.

The opinion states that in total, the POINT transactions shielded $2 billion in capital gains from federal taxes and generated $65 million in fees for Quellos. The officers, it said, "pleaded guilty to conspiracy to defraud the IRS of $240 million in taxes."

For 2004-2005, Quellos purchased layers of D&O liability insurance, including a primary-level investment management insurance policy—with a $10 million liability limit subject to a $2.5 million self-insured retention—from American International Specialty Lines Insurance Company (AISLIC). Quellos also purchased $10 million first-layer excess insurance from Federal Insurance Company, and $20 million second-level excess coverage from Indian Harbor Insurance Company.

When the IRS and federal prosecutors began closing in on the firm in 2006, Quellos sought reimbursement from the primary and first- and second-level excess insurance companies for $35 million in settlement costs, and $45 million in defense and other costs incurred in connection with multiple government investigations. Pursuant to a settlement agreement, AISLIC paid Quellos just under $5 million of the $10 million policy limit for 2004-2005, as well as other amounts for policies in other years. AISLIC subsequently did not agree to make any additional payments on the 2004-2005 policy.

Federal and Indian Harbor, however, then refused to pay "on the grounds that the underlying insurance limits had not been exhausted."

The Excess Policies

Federal's $10 million excess policy states: "Coverage hereunder shall attach only after the insurers of the underlying insurance shall have paid in legal currency the full amount of the underlying limit for such policy period." Indian Harbor's $20 million second-level excess policy was subject to the terms and limits of the Federal policy. With regard to the Indian Harbor policy, the opinion notes, "The record also shows that an amendment was available from Indian Harbor that allowed the insured as well as the underlying insurer to pay the full amount of the underlying policy limits to trigger excess coverage."

That is, Indian Harbor had a policy on the shelf that might have provided real insurance, but instead sold Quellos a policy with a gaping coverage hole. Policyholders might also wonder why Quellos's broker did not insist on the amendment. Policyholders and their brokers should take note that it's now vital to insist that excess D&O policies stipulate the policyholder's right to make up any shortfall in the underlying policy payout without surrendering excess coverage on exhaustion grounds.

The Quellos court held, "Because the exhaustion language in the Federal and Indian Harbor excess insurance policies is clear and unambiguous, we must enforce it as written, and affirm summary judgment dismissal of the lawsuit against Federal and Indian Harbor."

The court, unfortunately, rejected Quellos's argument that exhaustion was only a condition under the policies and that, as with "timely notice requirements," the insurer should have to show prejudice as grounds for denying coverage. This argument ought to carry weight on public policy grounds.

The Quellos decision is contrary to the long line of cases favoring compromise in insurance litigation, rather than forcing parties to ultimate judgment. It is contrary as well to the reasonable expectations of directors and officers who rely upon insurance to provide coverage.

Until recently, it had been accepted that settling a primary insurance claim would not compromise excess coverage. Now, thanks to a string of decisions, D&O insurance policyholders must make sure that excess policies are not booby-trapped with unduly restrictive exhaustion clauses that may permit insurers to make improper, extreme arguments that policyholders forfeit coverage for valid insurance claims. ■

William G. Passannante *is a shareholder and co-chair of Anderson Kill's insurance recovery group and is a leading lawyer for policyholders in the area of insurance coverage He has appeared in cases throughout the country and has represented policyholders in litigation and trial in major precedent-setting cases.*

Joshua Gold *is a shareholder in the New York office of Anderson Kill and regularly represents policyholders in insurance coverage matters and disputes concerning arbitration, time element insurance, electronic data and other property/casualty insurance coverage issues.*