Accessing Your Excess Insurance

by Joshua Gold

Over the last several years, excess level insurance companies have increasingly disputed and denied insurance coverage to their policyholders when the policyholder settles for less than full policy limits with one of its underlying insurance companies, including the primary level insurance company. While this tactic often fails to work a forfeiture of excess insurance coverage, it does present yet another insurance coverage headache that risk managers must confront.

What had been a settled legal point for many decades and a consistent way of doing insurance business (i.e., that insurance claim settlements were desirable and would not lead to a forfeiture of excess coverage) has been turned on its head in recent years. A potent reminder of this came several weeks ago when a federal appeals court held that a bank could not access some of its excess level insurance coverage after it settled with two underlying layers of insurance coverage for less than the full policy limits.

As such, before agreeing to accept less than full policy limits from an underlying insurance company in order to settle a claim, the policyholder must consider what the language of the excess policy (or policies) says about exhaustion and trigger, as well as the law governing the construction of the insurance policies. Keep in mind that this will not always be clear to policyholders given the convoluted language in some excess insurance policies and uncertainty over what law will apply.

The Typical Scenario

The usual scenario in which the exhaustion challenge by the excess insurance company arises is where the policyholder settles an insurance claim with an underlying insurance company (often the primary layer of insurance coverage) for less than 100 cents on the dollar. The policyholder then bridges the gap between the amount recovered from the underlying insurance company and the attachment point of the next level insurance company and seeks its excess coverage. The excess insurance company in turn denies insurance coverage by arguing that since the underlying insurance company did not pay the full policy limits, excess coverage is forever forfeited for the claim. This argument is made even where the policyholder "eats" the difference between the unpaid portion of the underlying insurance and the next excess policy attachment point. Thus, the denial comes even when the excess insurance company is not being asked to drop down or incur a financial obligation that it never bargained for.

The Legal Environment

Almost a century ago, a federal appeals court decided in Zeig v. Massachusetts Bonding and Insurance Co. that an excess insurance policy was triggered because a settlement with an underlying insurance company for less than full policy limits effectively exhausted that policy. According to the rule of Zeig, the "payment" of underlying policy limits could be satisfied through a settlement. The court also noted the very strong public policy favoring settlements. As a result, courts across the country followed the rule of Zeig for decades.

Over the past decade, however, several excess insurance companies appear to have drafted their excess policies to circumvent the Zeig holding. Based upon some of the new language found in excess polices, the trigger of excess coverage is tied to a cash payment of policy limits by the underlying insurance company. Some recent cases in 2007, 2008 and now 2011, however, have refused to apply the rationale of Zeig and have held that the policyholder's receipt of less than full underlying insurance policy limits forever impairs the ability to obtain excess insurance coverage-even where the policyholder absorbs the difference between the amount received and the excess insurance attachment point.

Do Not Leave Anything to Chance

While there are many courts that will still follow the rule and rationale of Zeig, policyholders are better off not leaving anything to chance. There are excess insurance policy forms that are not drafted in a manner to circumvent the Zeig holding. Excess policy forms that seek to prejudice policyholders for entering into compromise settlements with their underlying insurance companies should be avoided.

Also, even those excess insurance companies that employ language designed to avoid coverage when the policyholder receives less than full policy limits will often agree to endorse their policies to add favorable terms that provide coverage (even for those instances where the policyholder settles with an underlying insurance company for less than full policy limits or where one of the underlying insurance companies cannot pay in whole or in part due to insolvency).

Review the Terms

Many insurance brokers are now aware of this issue and will be able to guide policyholders toward more favorable terms to avoid any "exhaustion" disputes from excess level insurance companies. It is well worth the effort to be vigilant with excess insurance policy language up and down all the lines of insurance coverage that the policyholder purchases. Despite the use of "follow form" titles to describe excess insurance coverage, excess policies routinely possess unique terms and conditions. Regrettably, some of these terms are traps. Therefore, with each new policy year, insurance policies must be reviewed to make sure coverage is not compromised when needed most.■

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