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**Primary Challenges:  
Protecting Against and Pursuing Improper Erosion Challenges**

**I. The Rights and Obligations of an Excess Insurers**

**A. Excess Coverage Dynamics**

Excess insurance plays a critical role in protecting policyholders in a time where litigation is rampant and verdict sizes are on the rise. These insurers typically provide greater limits than the primary insurer, yet their role in the litigation is quite limited. This is mostly because standard excess liability policies do not impose on a duty to defend on excess insurers. To the contrary, these secondary policies typically provide that the excess insurer has no duty to investigate, defend, or settle any claim or suit. These limitations relieve these insurers of litigation costs and the obligation to manage the claim, but they also diminish the insurer's ability to control or affect the litigation.

In many cases, having the balance of power rest with the primary insurer is a bargain with which the primary and excess insurer are content. The primary insurer has a duty to pay indemnity from dollar one, while an excess insurer generally does not have a duty to indemnify until the underlying policy has been fully exhausted by actual payment. Nor does the secondary insurer typically have a duty to drop down in place of the primary policy, such as in cases of insolvency. Accordingly, these higher-level insurers can rest easy knowing that an underlying insurer will adjust the claim appropriately, both in terms of evaluating liability and damages and in terms of coverage. On each of these issues, the tower of insurers are typically aligned.

Their alignment on coverage arises from the follow form nature of excess coverage. Generally, standard excess policies adopt and incorporate the same terms, conditions, and exclusions of the underlying policy. Since they have the same terms, the primary and upper-level insurers typically have coverage for the same risks. So when a claim is reported to a tower of insurers, the upper layer insurers tend to rely on the

primary insurer to evaluate coverage and raise any potential limitations or bars to coverage in a comprehensive reservation of rights letter.

As discussed herein, excess insurers have the right to make their own, independent coverage determination. In fact, doing so frequently inures to the excess insurer's benefit.

### **B. An Excess Insurers Has The Right to Make Its Own Coverage Determination For a Single Claim**

In single claim disputes, the primary and excess insurers are free to form their own coverage determinations, even if they are at odds with one another. For example, the primary insurer may decide that a suit presents a covered claim, while the excess insurer may disagree. Although an excess policy follows form to the underlying policy terms, the excess insurer is usually free to accept or reject the primary insurer's coverage determination. The law in this area is well-settled. *See, e.g., Aspen Specialty Ins. Co. v. RLI Ins. Co.*, 194 A.D.3d 206 (N.Y. App. Div. 1st Dep't 2021); *Shy v. Ins. Co. of the Pa.*, 528 Fed. Appx. 752 (9th Cir. 2013); *Allmerica Fin. Corp. v. Certain Underwriters at Lloyd's, London*, 871 N.E.2d 418 (Mass. 2007); *Cristal USA Inc. v. XL Specialty Ins. Co.*, 2017 Md. App. LEXIS 210 (Md. Ct. Spec. App. Feb. 24, 2017) (unpublished)]. These courts have recognized that while the excess insurer offers the same coverage as the primary insurer, there is nothing in these policies that states that the excess insurer is bound by the primary insurer's coverage decision.

## **II. An Excess Insurer's Coverage Rights in Multi-Claim Settings**

Accidents or disparate acts leading to multiple lawsuits are another story. Notwithstanding broad agreement among courts that excess insurers are not bound by a primary insurer's coverage determination in a claim implicating both policies, courts have reached sharply different conclusions when deciding whether an excess insurer can challenge if a payment made by the primary insurer on a different claim properly erodes or exhausts the primary policy.

### **A. Common Multi-Claim Disputes Ripe For Conflict**

In any situation in which multiple claims are lodged against a policyholder implicating coverage in a single policy period, there is the potential for conflict between the primary and excess insurer, as well as the policyholder, on whether certain payments properly erode or exhaust the primary coverage. These claims may arise from a single catastrophic accident where there are multiple casualties, from mass tort claims alleging bodily injury or property damage across several policy periods, or where distinct lawsuits trigger a single tower of claims-made coverage. In all of these circumstances, the primary and excess insurers must be sensitive of their obligations to one another

and how they should adjust the claim to protect against accusations of improper claim handling and payments.

## **B. *AXIS Reinsurance Co. v. Northrop Grumman Corp.***

The most recent and most significant decision on an improper erosion challenge is *AXIS Reinsurance Co. v. Northrop Grumman Corp.*, 975 F.3d 840 (9th Cir. 2020). *AXIS* arose from two separate lawsuits against Northrop alleging Employee Retirement Income Security Act (ERISA) violations. Northrop settled both suits. One of those suits was by the Department of Labor (DOL). At the time, Northrop had a \$15 million primary policy with National Union, a \$15 million excess policy with CNA, and a \$15 million second layer excess policy with AXIS.

Under the AXIS policy, the insurer was required to drop down and provide coverage only when the combined \$30 million limit of liability of the underlying policies was exhausted by a covered loss. National Union determined that one of the settlements fell within its policy, so it paid its limit. CNA agreed that its policy also afforded coverage and paid the remainder of the settlement. Thereafter, CNA exhausted its limit through payment of Northrop's second settlement. When it was AXIS' turn to pay, it paid its share, but reserved the right to seek reimbursement because the settlement with the DOL was not covered.

In the coverage action, AXIS established that the payment for the DOL settlement was uncovered, but the Court of Appeals rejected the premise that AXIS had the right to challenge improper erosion of the lower-level policies. Instead, it adopted the rule that "unless there is an indication that the payments were motivated by fraud or bad faith, excess insurers generally may not avoid or reduce their own liability by contesting payments made at prior levels of insurance." In adopting this approach, the court focused on public-policy concerns and purported inefficiencies in the claims handling process and discounted the district court's concerns that such a conclusion would render the terms of AXIS' policy meaningless.

## **C. Considerations for Evaluating an Improper Erosion Challenge**

### **1. Policy Language**

Was the *Axis* decision consistent with the weight of authority, or is it an unsupported outlier? Regardless, it stands in contrast to decisions in other jurisdictions that have allowed for improper erosion challenges. Those decisions are invariably premised on the policy language allowing this recourse.

The decision in *Royal Indem. Co. v. C.H. Robinson Worldwide, Inc.*, 2009 Minn. App. Unpub. LEXIS 772 (Minn. App. Ct. 2009) illustrates the type of policy language that

will permit an improper erosion challenge. There, the excess insurer relied on the definition of “loss” to assert that a payment by the underlying insurers did not reduce its attachment point. That policy provided that the excess insurer’s “[l]iability for any covered loss...shall attach...only after the insurers of the underlying policies shall have paid in legal currency the full amount of the underlying limit and “[i]n the event...of the...exhaustion of the underlying limit by reason of the insurers of the underlying policies paying in legal currency loss, this policy shall...continue in force as primary insurance.”

Under this language, the “excess insurer attaches when the liability limits of the underlying policy have been exhausted because the underlying insurers have made payments for loss. Therefore, if [the underlying insurers] made payments that did not fit within the definition of ‘loss,’ the [insured] cannot rely on those payments to establish that the underlying policies have been exhausted.”

## **2. Jurisdiction**

An improper erosion challenge likely will have the best chance of success when there is clear and unambiguous language in the excess policy recognizing that only covered payments erode the primary limits. Thus, it is critical to know how your jurisdiction. Will your courts show unwavering commitment to the policy language or will they allow equitable considerations to factor into their decision. If the latter, consider your fact pattern. Improper erosion challenges --- because of their potential ramifications on the policyholder and primary insurer – require careful consideration of whether your argument will be perceived as fair.

### **C. Whether the Policyholder Or Primary Insurers Bears The Risk Of An Uncovered Payment**

In bringing improper erosion challenges, excess insurers have sought recourse from policyholders and primary insurers. *Compare Royal Indem.*, 2009 Minn App. Unpub. LEXIS 772 (seeking recoupment from the policyholder); *AXIS*, 975 F.3d 840 (same) with *Amerisure Mut. Ins. Co. v. Arch Specialty Ins. Co.*, 784 F.3d 270 (5th Cir. 2015) (suit by excess insurer against primary challenging exhaustion). From whom to seek recourse likely will depend on the facts and the policy language.

For instance, some excess policies, as a condition of coverage, may require that the limits of insurance of the underlying policies be maintained “except for any reduction or exhaustion of lifts by payments of claims or suits for damages covered by underlying insurance.” These policies further provide that “if you (the insured)” fail to comply with these requirements, we will only be liable to the same extent that we would have been had you fully complied with these requirements.” Based on the foregoing policy language, the secondary insurer could seek to hold the policyholder accountable for an uncovered payment by the primary insurer.

Nor is placing responsibility on the policyholder necessarily unfair. In some circumstances, the policyholder benefitted by the uncovered payment(s) because it settled or resolved a claim that would have otherwise required payment directly from the policyholder for the uncovered element. In other factual circumstances, putting the risk of loss on the policyholder because of a primary insurer's improper payment may be problematic, such as when a primary insurer pays to settle a lawsuit of questionable merit to avoid continued payment of defense costs outside of limits. In that case, the excess insurer may be best served by pursuing the primary insurer or both the policyholder and primary insurer.

## **II. Claim Handling Best Practices**

### **A. Excess Claim Professionals**

It is a common practice for excess insurance claim professionals to receive notification of a claim, perform an investigation to determine its potential to implicate the excess policy, and issue a letter to the policyholder and primary insurer advising that since the claim is unlikely to pierce the excess coverage, the file will be closed. Typically, the claim professional will close the letter by requesting to be looped in if the value changes. Although this is not a best practice, it is mostly harmless. In single claim disputes, the policyholder, primary insurer, and defense counsel will swiftly involve the excess insurer if circumstances change. But in multi-claim disputes, this claims handling practice can be detrimental to stopping the primary insurer from making an improper payment.

For example, if a single accident spawns several lawsuits, each presenting exposure that is unlikely to pierce the excess coverage, but with a collective value potentially exceeding the primary layer, it could be a mistake for the excess claim professional not to monitor the suits. All too often, claims that initially have limited value grow in severity as litigation proceeds. But in these circumstances, neither the primary insurer nor defense counsel may re-engage the excess insurer until after one or more lawsuits have been settled and the primary coverage is substantially eroded. If some or all of those payments were not covered, the excess claim professional is in the difficult position of justifying an improper erosion argument when he intentionally declined to monitor the litigation. Thus, be proactive.

Even if some cases have settled, the excess insurer should immediately communicate its disagreement with the primary insurer's coverage position as to settled and ongoing claims. Setting forth that position and explaining that you will not consider future payments to erode or exhaust the policy limit may alter the way in which the primary insurer adjusts the remaining claims.

### **B. Primary Claim Professionals**

Primary claim professionals have an exceedingly difficult task. They must balance the demands of the policyholder and the excess insurer which may be in tension, while at the same time exercising its duty of good faith and fair dealing to both sides. Complying with the demands of an excess insurer are also multi-faceted. Settle a case within the primary limit would protect the primary insurer from a bad-faith failure to settle claim, while opening the primary insurer up to an improper erosion challenge.

But handling a claim to defend against an improper erosion challenge does not need to add the strain. Instead, following claim handling best practices will go a long way. For example, there must be a well-documented basis for resolving a claim and for the quantum. If you pay an amount simply because that is what the claimant requires to settle the claim, you can reasonably expect an improper erosion challenge. In addition, ensure you provide your reservation of rights or partial disclaimer letter to the excess insurer. As the saying goes, “speak now or forever hold your peace.” To this end, provide, or instruct defense counsel to provide, periodic updates to the excess insurer on case developments. If the excess insurer is kept fully informed but remains silent as the primary insurer settles cases, not only will the record appear unfavorable to the higher-level insurer, but it could even create an estoppel argument.

There is no silver bullet to protect against an improper erosion challenge. But following best practices and perhaps taking that extra step to keep the excess insurer involved has the potential to mitigate against such claims.