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## Excess Insurer Issues

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John M. Sylvester  
Paul E. Del Vecchio

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### **I. Introduction**

#### A. What is excess insurance?

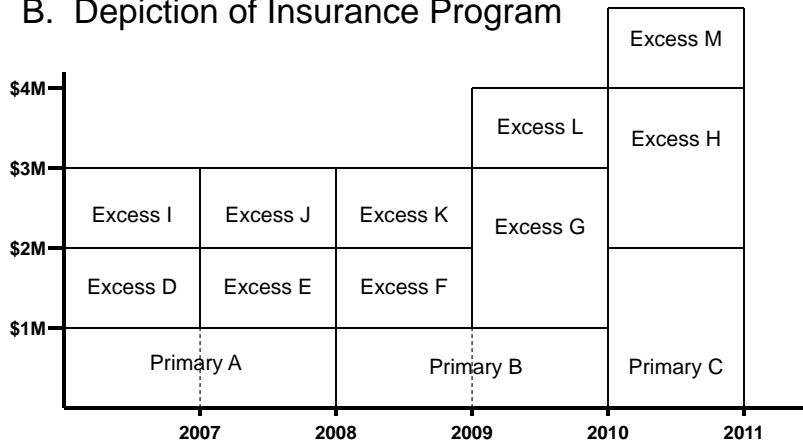
- Coverage for defense and indemnity that attaches above a primary policy or self-insured retention
- Insurance that provides protection for substantial or catastrophic losses
- Typically, no duty to defend but may assume defense upon exhaustion of primary policy

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## I. Introduction

### B. Depiction of Insurance Program



## I. Introduction

### C. Why is excess insurance a separate topic?

Significant disputes may arise involving excess policies:

- Policyholder problems accessing excess insurance
- Disputes between primary and excess insurers in same policy year
- Disputes between insurers involving multiple triggered policy years

## II. Topics

- Exhaustion of Underlying Insurance in the Ordinary Course
- “Functional” Exhaustion of Underlying Insurance through Settlement with the Underlying Insurer
- Excess Insurer’s Obligations to “Follow the Settlements”
- Excess Insurer’s Ability to Compel the Primary Insurer to Accept a Settlement Demand
- Excess Insurer’s Obligation to Contribute to Defense Costs when the Excess Policy Contains a Consent Clause
- Cyber Risk Insurance

## III. Exhaustion in the Ordinary Course

- Burden is on insurer seeking to transfer coverage responsibility through exhaustion of limits
- Proof may include claims files, records of payments, loss runs, canceled checks and wire transfer confirmation
- If multiple claims are involved, insurer may have to show that all claims arise from same occurrence
- Excess insurer may audit underlying insurer whose policy is exhausted

### **III. Exhaustion in the Ordinary Course**

- Policyholder can be “stuck in the middle” of transition from primary to excess insurance if there is a dispute over exhaustion
- Policyholder may need to be a facilitator
- Although policyholder may have remedies against its insurers, it may bear the financial burden until an exhaustion dispute is resolved

### **IV. Exhaustion – Settlement with Underlying Insurer**

- A hotly disputed issue is whether an excess insurer is excused from coverage responsibility if underlying insurer settles by paying less than full policy limits
- Excess Insurers are increasingly asserting this defense to coverage

#### **IV. Exhaustion – Settlement with Underlying Insurer**

##### **A. Traditional Rule – Zeig and its Progeny**

###### **1. The Rule**

- Policyholder can “functionally” exhaust policy and reach excess insurance with combination of settlement payment by primary insurer and agreement to pay difference between the settlement amount and policy limits
- Consistent line of cases since 1928 supporting the Zeig rule

#### **IV. Exhaustion – Settlement with Underlying Insurer**

##### **2. The Policy Rationale**

- Excess insurer has no rational interest in whether primary insurer actually pays policy limits, so long as excess insurer is only being asked to provide coverage in excess of its policy’s attachment point
- A contrary result that underlying insurer must pay entire policy limits or else excess insurer is excused would hinder insurance settlements and result in further protracted litigation

#### IV. Exhaustion – Settlement with Underlying Insurer

- Pereira v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA, No. 04 Civ. 1134, 2006 WL 1982789 (S.D.N.Y. July 12, 2006) – Professional Liability Insurance
- Court held policyholder could reach excess Directors and Officers liability policy even though primary insurer did not pay entire policy limits
- Part of basis of ruling was that the primary insurer was insolvent and unable to pay entire limits

#### IV. Exhaustion – Settlement with Underlying Insurer

##### B. Some Recent Decisions Reject Zeig Approach in the Context of Excess Directors and Officers Liability Insurance

- Three recent decisions – Comerica (E.D. Mich. 2007), Qualcomm (Cal. Ct. App. 2008), and Bally Total Fitness (N.D. Ill. 2010) – rejected Zeig approach in the context of excess D&O liability insurance
- Courts based their decisions on the interpretation of excess policy language that the underlying policy would be exhausted by payments of judgments or settlements or the full policy limits of the policy
- Decisions overlook that the Zeig approach places excess insurer in functionally equivalent position
- These three decisions are contrary to public policy favoring settlements of litigation

#### **IV. Exhaustion – Settlement with Underlying Insurer**

##### **C. Practical Implications**

- Policyholder should seek to insert policy language that addresses the issue (e.g., “shaving limits” endorsements)
- Policyholder should consider applicable exhaustion law of jurisdiction before entering settlement with primary insurer if excess insurance will be pursued
- May be prudent to seek excess insurer approval of settlement with primary insurer
- Overall, too soon to tell impact of Comerica, Qualcomm and Bally Total Fitness

#### **V. Excess Insurer Challenges of Primary Insurer’s Handling of Underlying Claim**

##### **A. Settlements of Underlying Claims**

- Excess insurer may seek to avoid being bound by a reasonable good-faith settlement if it can demonstrate that the settlement required its consent and such consent was not given
- Excess Insurer may not be bound to follow a settlement reached by a primary insurer if it is entered into in bad faith

**V. Excess Insurer Challenges of Primary Insurer's Handling of Underlying Claim**

**B. Issue can arise in "following form" context when excess and primary insurer are governed by the same policy language**

- The issue is whether a "following form" excess insurer is bound by underlying insurer's and policyholder's interpretation of policy language to which it follows form
- If excess insurer can show it materially relied on underlying policy language, it may be able to challenge policyholder's and underlying insurer's interpretation of the policy language that may be inconsistent with the language itself

**V. Excess Insurer Challenges of Primary Insurer's Handling of Underlying Claim**

**C. Practical Implications**

- Policyholder may be "stuck in the middle"
- Policyholder may have to assume the share of excess insurer until primary v. excess insurer dispute is resolved
- Excess insurer decision to reject settlement subject to heavy scrutiny
- Excess insurer may be subject to extra-contractual damages claims if it prevents a settlement (e.g., bad faith)

**VI. Excess Insurer's Remedies Against a Primary Insurer for Failure to Accept a Settlement Demand Within Primary Policy Limits**

**A. The "Stowers" Duty**

- Texas Court of Appeals decision from 1929
- Primary insurer owes a duty of good faith to the policyholder when deciding whether to accept a settlement demand
- Demand must be within coverage and policy limits
- Demand must be reasonable under the circumstances
- Failure to settle may subject primary insurer to extra-contractual damages – liability greater than limits

**VI. Excess Insurer's Remedies Against a Primary Insurer for Failure to Accept a Settlement Demand Within Primary Policy Limits**

**B. Extension of "Stowers" Duty to Excess Insurers**

- In 1992, Texas extended Stowers decision
- Permits an excess insurer to pursue a cause of action against a primary insurer for failing to settle a claim within primary policy limits
- Basis for Texas rule is the excess insurer's subrogation rights – "standing in the shoes" of the policyholder

**VI. Excess Insurer's Remedies Against a Primary Insurer for Failure to Accept a Settlement Demand Within Primary Policy Limits**

**C. Excess Insurers May Invoke "Stowers" Duty**

- Excess insurer must show that primary insurer has failed to fulfill duty owed to policyholder
- Primary insurer's defenses could include failure of excess insurer to cooperate in defense/settlement
- Limited rights – sue for negligence and damages in amount of payment under excess policies (i.e., no statutory or punitive damages remedies available)

**VI. Excess Insurer's Remedies Against a Primary Insurer for Failure to Accept a Settlement Demand Within Primary Policy Limits**

**D. Other Jurisdictions**

- Most states provide excess insurer with remedy through equitable subrogation (e.g., Pennsylvania, Maryland, Ohio, Indiana, California)
- PA Supreme Court decision in 1957
  - Requires excess insurer to make showing of bad faith by clear and convincing evidence (bad judgment is not enough)
- Minority of states have provided a cause of action based on direct duty of primary insurer owed to excess insurers (e.g., New Jersey, New York, West Virginia)

**VII. Consent Clauses for Defense Costs  
in Excess Insurance**

**A. Excess Insurer May Still be Required to Cover  
Defense Costs Absent Formal Consent**

**1. Courts May Impose a Reasonableness Standard  
on Excess Insurer**

- Excess insurer cannot unreasonably or arbitrarily withhold its consent to policyholder incurring defense costs – implied duty of good faith and fair dealing
- May only withhold consent entirely where policyholder incurs unreasonable expenses without prior consent
- Excess insurer retains right to reasonable exercise of discretion to refuse consent for defense costs

**VII. Consent Clauses for Defense Costs  
in Excess Insurance**

**2. Excess Insurer Denies Coverage or Fails to  
Respond to Requests for Consent – Consent  
Clauses May Be Rendered Futile or Unenforceable**

- Excess insurer denies coverage – any attempts to obtain consent would have been futile
  - Approach applied in various types of insurance policies
- Excess insurer fails to respond to notices or requests for consent – excess insurer estopped from asserting failure to obtain consent

## VII. Consent Clauses for Defense Costs in Excess Insurance

### B. Excess Insurer's Consent as a Requirement for a Primary Insurer to Recover Reimbursement of Underlying Defense Costs

- When a primary insurer seeks to recover defense costs incurred in defending the underlying claim in the absence of consent, the excess insurer has substantial discretion to cover underlying defense costs
- Applied in the context of a professional liability excess policy
  - Gen. Accident Ins. Co. of Am. v. Am. Ins. Co., No. CIV. A. 99-3869, 2000 WL 92097 (E.D. Pa. Jan. 27, 2000).

## VII. Consent Clauses for Defense Costs in Excess Insurance

### D. Practical Implications

- Policyholders and primary insurers should review excess policies for consent clauses when a claim implicates excess coverage
- If applicable, actively seek consent of excess insurer to defense costs
- In event of "reasonableness" requirement, be prepared to demonstrate why costs are reasonable/denial of consent is unreasonable
- To preserve rights, excess insurers should respond to requests for consent in a timely manner

**VIII. Excess Insurer Contesting Defense Costs  
When Underlying Defense is Successful**

- Certain excess insurers may take the position that, if an underlying claim is successfully defended, the associated defense costs are not covered by their excess policy because such costs do not fall within the policy's definition of "Ultimate Net Loss"
- These excess insurers contend that, if the underlying claimant was unable to prove its allegations, the policyholder cannot show that the underlying claim was a covered claim

**VIII. Excess Insurer Contesting Defense Costs  
When Underlying Defense is Successful**

- This position makes excess coverage illusory for claims that are within the policy's coverage but are successfully defended
- This position is nonsensical - if a policyholder were to lose the defense of the exact same underlying claim, or to settle the claim, there would be coverage for both defense costs and indemnity

## **IX. Take Away Points – Excess Insurance**

- Evaluate early whether a claim's value might involve excess insurance
- Provide timely notice to excess insurers of claim
- Keep excess insurers in the loop on defense and settlement strategy

## **IX. Take Away Points – Excess Insurance**

- Evaluate carefully the need to include excess insurer in settlement negotiations:
  - with claimants on underlying claims
  - with primary insurer on coverage claim
- Excess insurer and policyholders may work together to convince a primary insurer to accept a settlement demand within its policy limits

## IX. Take Away Points – Excess Insurance

- Insist that primary insurer maintain proper records documenting exhaustion of limits
- Try to obtain policy language that provides the policyholder maximum flexibility to resolve claims with available coverage
- Be aware of defense costs provision in excess insurance policies

## X. Insurance for Cyber Risks

### A. Why Consider Cyber Risk Insurance?

- Escalating Cyber Attacks - Not a question of “if” but “when”
  - Majority of companies will suffer at least one network breach incident each year
  - Data breaches at large companies: Sony, Google, Citi were targeted in 2011
  - An Epsilon Data Management breach exposed e-mail addresses of Target and TiVo customers, leaving customers exposed to future phishing scams
- Increased Exposure to Breach
  - Companies rely on networks connected with third parties with inadequate protection
  - Attackers are increasingly sophisticated
- Growing Industry Norm
  - One-third of American companies surveyed possess insurance for cyber risks
  - An additional one-fourth plan to buy cyber risk insurance in the near term
- Cost
  - Average breach estimated to cost almost \$7 million but total may be much higher

## X. Insurance for Cyber Risks

### B. What Types of Risks Do Companies Face?

- “Cyber Risk” Can Encompass a Number of Threats
  - **Hacking**
    - Access without authorization (can be internal or external)
  - **Information Extortion**
    - Sensitive or confidential information
    - Computer Fraud and Abuse Act sets penalties
  - **Time or Logic Bombs**
    - Date or data thresholds
    - Plan for holidays or weekends to evade discovery
  - **Malware**
    - Key/Screen logging, e-mail redirectors
    - Remote takeover of computer

## X. Insurance for Cyber Risks

### B. What Types of Risks Do Companies Face?

- “Cyber Risk” Can Encompass a Number of Threats
  - **Denial-of-Service Attacks**
    - Direct attack against network or server
    - “Upstream” attack on service provider
  - **Lost or Stolen Information**
    - Laptops, mobile devices, data
    - Phishing schemes
      - Posing as a legitimate business to obtain confidential information
    - Pharming schemes
      - Redirecting web traffic from a legitimate website to a shame website to defraud users
  - **Employee Mistakes**
    - E-mails (especially attachments), blogs and instant messaging
  - **Rogue Employees or Contractors**
    - Many security breaches implicated business partners
- **Publicly Traded Companies**
  - Stock impact after discovery of breach
  - May need to disclose incident on SEC filing
  - Media scrutiny of breach

## **X. Insurance for Cyber Risks**

### **B. What Types of Risks Do Companies Face?**

- **The Consequences of Data Breaches**
  - Lengthy and costly forensic data recovery/audit
  - Notifying and assisting affected customers
  - Credit monitoring for affected customers
  - Compensation to banks for fraudulent charges
  - Retaining legal counsel
    - Draft customer notice letters
    - Defend federal/state investigations and civil class action lawsuits
  - Repairing damage to company reputation with customers, partners, and affiliates

## **X. Insurance for Cyber Risks**

### **C. Why Specialty Cyber Risk Insurance?**

- **Traditional CGL and Property Policies May Not Cover Cyber Risks**
  - Exclusions, court decisions
- **Many Companies Now Obtain Cyber Risks Policies**
  - More insurers have entered market
  - Underwriting process simplified, premiums decreasing
  - Not standard form policies – terms are subject to negotiations and may vary greatly

## **X. Insurance for Cyber Risks**

### **D. Cyber Policies May Afford First-Party Coverage**

- Protects insureds from direct losses as a result of a data breach or loss. Coverage may include:
  - Cost of replacing/recovering lost data
  - Forensic investigation expenses
  - Customer notification costs
  - Credit monitoring services/customer call center costs
  - Cyberterrorism or extortion demands
  - Reward expenses
  - Crisis management/public relations expenses

## **X. Insurance for Cyber Risks**

### **E. Cyber Policies May Afford Third-Party Coverage**

- Protects insured from losses it allegedly causes to another (such as customers and financial institutions).
- Coverage may include:
  - Regulatory claims
  - Defense costs and damages in civil suits
  - Defamation, libel, or invasion of privacy
  - Fines and penalties imposed by regulatory agencies
  - Unauthorized access and identity theft
  - Copyright/trademark infringement

## **X. Insurance for Cyber Risks**

### **F. Common Exclusions may bar coverage for:**

- Intentional acts
- Failure to upgrade security policies and procedures
- Malfunction due to programming error
- Spyware/malware
- Loss caused by an employee
- Loss due to any shortcoming in a computer system that an insured knew about prior to the inception of the policy
- Loss due to a failure in the design or configuration of a computer system