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Second Circuit Weighs in on D&O Excess Coverage

A recent hot topic in the world of directors and officers (D&O) liability insurance is the application and interpretation of excess coverage. With increased frequency, courts across the country have limited policyholders' ability to tap into this coverage, despite the existence of covered liability that reaches excess layers. *See, e.g.*, *Qualcomm, Inc. v. Certain Underwriters at Lloyd's, London*, 161 Cal. App. 4th 184 (2008) (holding that a settlement for less than a carrier's policy limits has the effect of releasing any excess carrier from its coverage obligations); *Forest Labs., Inc. v. Arch Ins. Co.*, 953 N.Y.S.2d 460 (2012) (same).

The U.S. Court of Appeals for the Second Circuit recently entered the fray with its decision in*Ali v. Federal Insurance Co.*, 719 F.3d 83 (2d Cir. June 4, 2013). In *Ali*, the Second Circuit held that where the excess policies at issue applied only upon exhaustion of underlying coverage "as a result of payment of losses," these policies were triggered solely through liability payments meeting their attachment points, not through the existence of liability exceeding the underlying limits. Consequently, the policyholders could not seek excess coverage in a case where both the underlying carriers were insolvent and unable to pay the limits of their policies, and the entity itself also could not pay the "gap."

Not surprisingly, policyholder counsel have found much to disagree with in this opinion. First, it limits policyholders' ability to recover for incurred liability through circumstances that are not within the policyholders' control, and is contrary to a policyholder's intent when purchasing excess coverage. Second, the holding does not serve any rational interest of insurance carriers. To the extent that insurers are concerned about policyholders agreeing to inflated settlements with third parties in order to more quickly exhaust insolvent coverage, this concern can be addressed by a court's determination of the existence of fraud; a carte blanche prohibition on accessing excess coverage where the underlying liability has not been paid is vastly over-inclusive. Third, although the court did not address it, the decision violates the intent of the provision, common in D&O coverage, that the bankruptcy or insolvency of an insurer does not affect a policyholder's ability to recover for its losses.

It is worth noting, however, that while it surely will further embolden insurers in negotiations and coverage litigation, the Second Circuit's holding in *Ali* may not be as harmful to policyholders at it appears at first blush. The court specifically leaves open the door to a policyholder triggering excess solvent coverage by paying the insolvent carrier's liability limits himself. In other words, *Ali v. Federal* is expressly not *Qualcomm*, and a circumstance where both the underlying carrier is insolvent and the policyholder cannot pay the liability will be somewhat infrequent.

So, what should policyholders do to protect themselves? We suggest the following:

First, and most obviously, if you are seeking new D&O coverage, ensure that the policy does not include a trigger provision that requires payment of liabilities prior to attachment. Certain D&O policies specifically provide that an excess carrier's obligations "drop down" to provide coverage when the underlying carrier is insolvent.

To the extent that you have an existing D&O coverage claim, and certainly in the case of a dispute, consider the extent of the risk you face on this issue at the outset. Very small variations on policy language and choice of law make all the difference in these cases, and a close analysis is required. Sophisticated modeling of potential outcomes may, in certain cases, justify resolution of underlying coverage for less than limits, even where these risks exist. Where you face a greater risk, factor this risk into your settlement analysis.

Maintain underlying defense and settlement data comprehensively in an organized electronic medium to be able to value the risks and evaluate various settlement options in the context of these issues. This requires coordination of various parties in the earlier stages of defending the underlying case to insure all the data you may need is being tracked.

Where you have significant risk, consider creative settlement arrangements, such as a “top-down” structure where you settle with excess carriers first, or contingent arrangements that make settlement agreements with underlying insurers contingent on your ability to resolve excess coverage favorably.

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