When You're Living Life In Excess, It Pays To Know Your Rights!:
A Quick-Reference Handbook on Excess Liability Insurance

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Table of Contents

I. Introduction *4*

II. The Basics: Primary, Excess, Umbrella Policies and Self-Insured Retentions and Deductibles *5*

A. Primary Insurance 5
B. Excess Insurance 5
1. "True" Excess Insurance 5
2. "Implied" Excess Insurance 6
3. Scope of Excess Insurance Policy Coverage 6
a. "Stand Alone" Excess Policy 6
b. "Following Form" Excess Policy 6
c. "Broad as Primary" Excess Policy 7
4. Triggers of Excess Insurance Policy Coverage 7
a. "Specific Excess" Excess Trigger 7
b. "Broad As Primary" Excess Trigger 7
5. Common Excess Policy Features 8
a. Scope and Trigger of Defense Duty 8
b. Types of Expenses Policy Will Pay 8
6. Excess Insurance by Operation of Law 8
7. Excess Insurance by "Other Insurance" Clause 8
C. Umbrella Policies 10
D. Self-Insured Retentions and Deductibles 11

III. Trigger for Duties to Defend and Indemnify: Exhaustion *11*

A. Duty to Defend 12
1. Existence of Defense Duty 12
2. Extent of Defense 12
B. Duty to Indemnify 12
C. Definition of "Exhaustion" 12
1. "Exhaustion" in a Continuing Loss Case 13
a. Triggers Relating To The Condition Of The Applicable Primary Policies 13
b. Triggers Relating To The Exhaustion Status Of Specific Underlying Insurance 13
(1) "Specific Excess" and "Vertical Exhaustion" 13
(2) "Broad as Primary" and "Horizontal Exhaustion" 14
2. Insolvency As "Exhaustion" 14
3. Mixture of "Specific Excess" and "Broad as Primary" Policies Over Multiple Policy Periods 14

IV. The "Drop Down" Principle *15*

A. The "Drop Down" Triggers 15
1. Underlying Insurer Insolvency 15
a. Excess Insurer's Duty to Inquire 16
2. Underlying Insurer Refusal to Defend 16
B. Whether "Dropping Down" Is Required 17

1. Determining Whether Excess Policy Language Is "Clear and Unambiguous" 18
a. Specific Language Disclaiming "Drop Down" Duty 18
b. Unclear and Ambiguous "Drop Down" Duty Language 19
(1) "Amount Recoverable" 19
(2) "Exhaustion of Underlying Insurance" 19
(3) "Covered" 19
(4) "Maintenance of Underlying Insurance" Clause 20
c. Out-of-State Analysis of "Drop Down" Question 20
C. Advisability of Voluntarily "Dropping Down" 20

IV. Effects of Primary Carrier "Exhaustion" and "Drop Down" Triggers on Additional Insured Carriers 21
A. What Is an Additional Insured Endorsement ("AIE")? 21
B. Scope of AIE Coverage 22
1. ISO AIE Form Commonalities 22
C. Apportionment of Responsibility for Defense and Indemnity Costs Among Primary, AI, and Excess Insurers 27
1. Calculation of Pro Rata Share of Loss 28
2. Sources of Payment for the Loss: AI and Excess Carriers 28

V. Notice of Claims to Excess Insurers 29
A. Insured Notice of a Claim 29
B. Primary Insurer Notice of a Claim 29
C. Proper Notice 29
1. Timeliness of Notice 29

VI. RESPONSE TO CLAIM EXCEEDING EXCESS POLICY LIMITS 30
A. Claim Acknowledgement 30
B. Coverage Is Clear 30
C. Reservation of Rights 31

VII. SETTLEMENT OF CLAIMS EXCEEDING PRIMARY INSURANCE 32
A. Duty of Good Faith and Fair Dealing 32
1. Insured's Duty of Good Faith and Fair Dealing to the Excess Insurer 32
2. Excess Insurer's Duty of Good Faith and Fair Dealing to the Insured 33
3. Good Faith and Equitable Obligations Between the Primary and Excess Carriers 33
a. Failure to Settle Within Primary Policy Limits 33
(1) "Bad Faith" Letter Before Settlement Occurs 34
(2) "Bad Faith" Letter After Settlement Occurs 34
(3) "Triangular Reciprocity" Theory 35
(4) "Independent and Direct Duty" Theory 35

VIII. CONCLUSION 36

I. Introduction

Because of larger jury awards, increased “burning” of policies, more expensive repair costs, and increased sophistication of the parties, excess insurance has begun to play an increasingly important role in handling of construction defect and other continuing loss claims. Primary and additional insured carriers who are well-versed in the specifics of the legal obligations that exist between themselves and excess insurance carrier are better-equipped to make keen business decisions when handling these claims.

The goal of these materials is to set forth as succinctly as possible the rules that apply when a carrier has notice that a given claim may exceed primary policy limits. Among the most important of these are the laws relating to “exhaustion” and “dropping down,” two separate and distinct concepts. Often primary carriers, faced with a claim exceeding their limits, ask, “Why doesn’t the excess carrier drop down?” The purpose of these materials is to inform these carriers about the various legal duties they owe excess carriers and the duties excess carriers owe them. Only after understanding these obligations, can “exhaustion,” insolvency, and refusal to defend problems be solved.

First discussed in these materials are the basics about the legal relationships between primary and excess insurance policies. The concept of “exhaustion” is then detailed. Explained next is the “drop down” principle. The effects of “exhaustion” and/or “dropping down” on additional insured carriers is then described. Next, the materials discuss proper and timely notice of claims likely to exceed primary policy limits and proper responses to the notice by excess carriers. Finally, the process of settlement and litigation of claims implicating excess coverage is explained in detail.

The materials are designed to assist both insurance professionals and construction attorneys alike. Rules appear with usually multiple citations for further reading or verification. Examples of real-life application of excess insurance laws are included to help readers fully grasp their intricacies. All possible efforts were taken to incorporate relevant information from every case, treatise, and reference material discussing California and other states’ law of excess insurance. Thus, it is hoped that the following discussion will be of benefit to you now and in the future.

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II. The Basics: Primary, Excess, Umbrella Policies and Self-Insured Retentions and Deductibles

A. Primary Insurance

"Primary insurance coverage is insurance coverage whereby, under the terms of the policy, liability attaches immediately upon the happening of the occurrence that gives rise to liability." *Hartford Accident & Indemnity Co. v. Sequoia Ins. Co.*, 211 Cal. App. 3d 1285, 1295 (Cal. Ct. App. 5th 1989); *Olympic Ins. Co. v. Employers Surplus Lines Ins.*, 126 Cal. App. 3d 593, 597-98 (Cal. Ct. App. 1st 1981). *See also Whitehead v. Fleet Towing Co.*, 110 Ill. App. 3d 759, 764 (Ill. App. Ct. 5th 1982); *Union Indemn. Ins. Co. v. Certain Underwriters at Lloyd's*, 614 F. Supp. 1015, 1017 (S.D. Tex. 1985). Primary insurers have the initial duty to defend and indemnify the insured unless they are excused from the obligation by specific policy language. *Fireman's Fund Ins. Co. v. Maryland Cas. Co.*, 65 Cal. pp. 4th 1279, 1304 (Cal. Ct. App. 1st 1998).

B. Excess Insurance

Like the word "happiness," the term "excess insurance" means different things to different people. Insurance that is always excess to primary is sometimes referred to as "true," "pure," or "straight" excess insurance. *See* Dennis Wall, *Litigation & Prevention of Insurer Bad Faith*, 2d Ed. § 6:3 (July 2003) (discussing labels for "true" excess insurance). Insurance that, depending on a given situation, may function as primary, excess, or umbrella may be termed "implied" excess insurance.

1. "True" Excess Insurance

True "'[e]xcess' or secondary coverage is coverage whereby, under the terms of the policy, liability attaches only after a predetermined amount of primary coverage has been exhausted." *Wells Fargo Bank v. California Ins. Guarantee Assn.*, 38 Cal. App. 4th 936, 940 n.2 (Cal. Ct. App. 1st 1995); *Hartford*, 211 Cal. App. 3d at 1295. Generally, insureds contract for true excess insurance to protect them from losses "in excess," or above, primary policy limits. In some situations, the excess insurance coverage is purchased to cover an insured for losses above its self-insured retention. However, more often than not, true excess insurance "kicks in" only after the primary coverage has been exhausted. *Wiemann v. Industrial Underwriters Ins. Co.*, 177 Cal. App. 3d 38, 41 (Cal. Ct. App. 2d 1986); *Aetna Cas. & Sur. Co. v. Certain Underwriters at Lloyds*, 56 Cal. App. 3d 791, 804-05 (Cal. Ct. App. 2d 1976).

Excess policies may be written as excess to: (1) a specific policy or policy number; (2) coverage provided by a particular insurer; (3) secondary insurance of identified policies; or (4) coverage of any other underlying insurance providing coverage to the insured. Additionally, true excess

insurance generally is only applicable after substantial loss payouts, and thus, it is cheaper to purchase.

2. "Implied" Excess Insurance

Insurance professionals also use the term, "implied excess insurance" or merely "excess insurance" to broadly describe secondary insurance. Secondary insurance refers to every policy that applies after primary coverage is exhausted or otherwise unavailable. Thus, secondary insurance could include excess, umbrella, and even primary insurance policies. In this context, the distinction between primary and excess insurance is simply the order in which each policy pays money on a claim against a common insured. *See* Cal. Ins. Code §§ 11580.8, 11580.9 (providing order of insurance coverage for automobile insurance policies); *Hellman v. Great American Ins. Co.*, 66 Cal. App. 3d 298, 305-06 (Cal. Ct. App. 1st 1977). *See also Whitehead*, 110 Ill. App. 3d at 764 (determining order of applicable insurance policies); *Maine Bonding & Casualty Co. v. Centennial Ins. Co.*, 693 P. 2d 1296, 1297-1302 (Or. 1985) (discussing in detail the relationship and duties of primary and excess carriers).

3. Scope of Excess Insurance Policy Coverage

Most construction attorneys and insurance professionals see in their practice that the scope of an excess policy's coverage is generally one of three types: (a) "stand alone"; (b) "following form"; or (c) "broad as primary."

a. "Stand Alone" Excess Policy

The terms of a "stand alone" excess policy are not in any way tied to the terms of the underlying policy(ies). International Risk Management Institute, *Umbrella / Excess Comparison Checklists*, 2 (Oct. 1996). This type of policy typically provides that coverage applies in excess of a retained amount. *Id.* The means by which the retention is met have no affect on coverage. Terms, conditions, and exclusions may be broader and/or narrower than those of underlying policies. *Id.*

b. "Following Form" Excess Policy

The most common excess policy scope is "following form." A following form policy is written on the same terms and conditions as a primary policy. *Coca Cola Bottling Co. v. Columbia Casualty Ins. Co.*, 11 Cal. App. 4th 1176, 1183 (Cal. Ct. App. 4th 1992); *Trailer Marine Trans. Corp. v. Chicago Ins. Co.*, 791 F. Supp. 809, 810 (N.D. Cal. 1992). Following form policies generally incorporate by reference the provisions of underlying coverage, save the premium, liability limits, and the duty to investigate and defend. *Coca Cola*, 11 Cal. App. 4th at 1183; Dennis Wall, *Litigation & Prevention of Insurer Bad Faith*, 2d Ed. § 6:9 (July 2003).

Although the phrase "following form" implies that the terms and conditions of underlying insurance are the terms and conditions of the excess policy, ***they are not***. Richard Masters, *Commercial Umbrella and Excess*

Liability Coverages, 4 (Apr. 2004). Too many times insureds assume that a claim exceeding primary policy limits is covered by excess insurance because they had the good sense to procure a following form policy. This is not true in most cases. Following form carriers describe in the exclusion sections of their policies how coverage differs from underlying policies. International Risk Management Institute, *Umbrella / Excess Comparison Checklists*, 2 (Oct. 1996). Thus, insurance representatives and insureds are advised to review "follow form" policy exclusions before tendering to excess carriers.

Following form excess carriers are not bound by an insurer's changes to underlying coverage, unless they consent to them. However, an excess carrier is bound to an insurer's primary policy alterations to correct a mutually mistaken term on which the excess carrier did not rely when issuing the "following form" policy. *R.W. Beck & Assocs. v. City and Borough of Sitka*, 27 F. 3d 1475, 1480-82 (9th Cir. 1994).

c. "Broad as Primary" Excess Policy

"Broad as primary" policies cover "a loss which is covered under the policies of underlying insurance." *Housing Group v. California Ins. Guar. Ass'n*, 47 Cal. App. 4th 528, 531 (Cal. Ct. App. 4th 1996). *See also R.W. Beck*, 27 F. 3d at 1480-82. "Broad as primary" excess insurance is often a practical purchase because it can cost less and provide "following form" type coverage. That is because the policy covers damages after exhaustion so long as they were covered by a primary policy. This obligation exists notwithstanding the "broad as primary" policy's own exclusions. *Housing Group*, 47 Cal. App. 4th at 531-32. Note, however, that as described below, "broad as primary" coverage is often triggered later than other policy types.

4. Triggers of Excess Insurance Policy Coverage

Many confuse the scope of an excess policy with the trigger of an excess policy. Scope refers to how far coverage extends, whereas trigger refers to when coverage begins. Generally, two types of excess policy triggers exist: (a) "specific excess"; and (b) "broad as primary."

a. "Specific Excess" Excess Trigger

Specific excess insurance is triggered when the coverage of a specifically identified primary policy is exhausted. *Olympic*, 126 Cal. App. 3d at 598. Note that a "specific excess" policy is the only type that may be triggered before "exhaustion" of all primary coverage.

b. "Broad As Primary" Excess Trigger

"Broad as primary" coverage describes both a scope and a trigger of excess insurance. As discussed above, this type of excess policy has the same breadth as all other primary policies. However, for "broad as primary" coverage to become applicable, all underlying primary insurance must be exhausted.

5. Common Excess Policy Features

Like most other "big-dollar" purchases, the more excess policy features you want, the more the policy will cost. The following discusses common excess policy features:

a. Scope and Trigger of Defense Duty

Some excess policies specifically exclude a duty to defend in all cases. Others give the excess insurer the option to defend. Others provide that the duty to defend is automatically triggered when primary coverage is exhausted. Still others exclude the duty to defend, but give the excess insurer the "right to associate" with another insured's defense counsel. *See Chubb / Pacific Indem. Group v. Ins. Co. of No. America*, 188 Cal. App. 3d 691, 695-96 (Cal. Ct. App. 2d 1987).

b. Types of Expenses Policy Will Pay

The types of expenses that an excess policy will pay is often a feature subject to negotiation. Insureds often choose "ultimate net loss" excess policies. Under these policies, once exhaustion occurs, the insurer is obligated to pay for direct or consequential damages and expenses the insured "becomes obligated to pay by reason of bodily injury or property damage claims . . . and shall also include . . . all sums paid as salaries, wages, compensation, fees, charges and law costs, . . . expenses for doctors, lawyers, nurses and investigators and other persons, and for litigation, settlement, adjustment and investigation of claims and suits which are paid as a consequence of any occurrence covered hereunder." International Risk Management Institute, *Umbrella / Excess Comparison Checklists*, 4 (Oct. 1996). *See AIU Ins. Co. v. Sup. Ct.*, 51 Cal. 3d 807, 814-15 (Cal. 1990). An excess policy with an "ultimate net loss" provision covers many more obligations than policies that pay for mere damages. *AIU Ins. Co.*, 51 Cal. 3d at 842 n.19. Additionally, amounts included in the "ultimate net loss" are chargeable against the policy limits. *Umbrella / Excess Comparison Checklists*, 4.

6. Excess Insurance by Operation of Law

When primary insurance "overlaps," viz. two or more polices provide coverage for the same risk, one of the primary policies may be transmuted to excess insurance. Often, specific statutes create excess insurance by operation of law. For example, California Insurance Code § 11580.9 provides guidelines for determining which primary automobile insurance policy will become excess to the others. *Hartford Acc. & Indem. Co. v. Sequoia Ins. Co.*, 211 Cal. App. 3d 1285, 1296 (Cal. Ct. App. 5th 1989).

7. Excess Insurance by "Other Insurance" Clause

The "other insurance" clause of a liability policy provides rules for how coverage shall be allocated among two or more of the insured's policies. *Olympic Ins. Co. v. Employers Surplus Lines Ins.*, 126 Cal. App. 3d 593, 598 (Cal. Ct. App. 1st 1981). "Historically, 'other insurance' clauses were designed

to prevent multiple recoveries when more than one policy provided coverage for a particular loss." *Fireman's Fund Ins. Co. v. Maryland Cas. Co.*, 65 Cal. pp. 4th 1279, 1304 (Cal. Ct. App. 1st 1998).

The *Olympic* court identified three different types of "other insurance" clauses. They are the following:

- **Pro rata**: This clause provides that if there is other valid and collectible insurance, then the insurer shall not be liable for more than his pro rata share of the loss.

- **Excess**: This clause provides that if there is other valid and collectible insurance, then the insurer shall not be liable except to the extent that the loss exceeds such other valid and collectible insurance (i.e., this policy shall be excess to other valid and collectible insurance).

- **Escape**: This clause provides that the insurer is not liable for any loss that is covered by other insurance (i.e., the existence of other insurance extinguishes insurer's liability to the extent of such other insurance).

Olympic, 126 Cal. App. 3d at 598.

Interpretation of the "other insurance" clause is usually at the heart of resolving disputes between multiple insurers with policies covering the same loss. Thomas W. Johnson, Jr., *Identifying and Using Insurance Coverage in Business Litigation*, 74 (March 1991). While courts say that they generally honor the language of excess 'other insurance' clauses when no prejudice to the interests of the insured will ensue, often insureds can show some sort of prejudice. And even a small showing of prejudice causes courts to disregard the conflicting "other insurance' clauses.

This rule was established in *Travelers Casualty & Surety Co. v. American Equity Ins. Co.*, 93 Cal. App. 4th 1142 (Cal. Ct. App. 1st 2001). There, the court held "where two or more primary insurers' policies contain excess 'other insurance' clauses purporting to be excess to each other, the conflicting clauses will be ignored and the loss prorated among the insurers on the ground the insured would otherwise be deprived of protection." *Id.* at 1149-50. Thus, while an excess carrier generally has no duty to defend or indemnify until all the underlying primary coverage is exhausted, primary insurers with conflicting "other insurance" clauses can have immediate defense obligations. *Id.* at 1150; *Fireman's Fund Ins. Co. v. Maryland Casualty Co.*, 65 Cal. App. 4th 1279, 1305 (Cal. Ct. App. 1st 1998). Courts disregard the conflicting clauses and obligate insurers to share pro rata in defense and indemnity costs. *Fireman's Fund*, 65 Cal. App. 4th at 1307.

Note that an "other insurance" dispute "can arise only between carriers on the same level; it cannot arise between excess and primary insurers." *North River Ins. Co. v. American Home Assurance Co.*, 210 Cal. App. 3d 108, 114 (Cal. Ct. App. 2d 1989).

C. Umbrella Policies

In discussions about insurance, "excess" and "umbrella" are often used interchangeably. *See CSE Ins. Group v. Northbrook Property & Casualty Co.*, 23 Cal. App. 4th 1839, 1844 n.1 (Cal. Ct. App. 2d 1994) (stating "[a]ll umbrella policies are excess policies in the sense they afford coverage that is excess over underlying insurance"). However, there is a difference. Umbrella policies are secondary insurance, but they often provide broader coverage than even primary insurance. *See Reserve Ins. Co. v. Pisciotta*, 30 Cal. 3d 800, 812 (Cal. 1982) (stating that umbrella coverage fills "any gaps in coverage left open by the primary coverage in addition to increasing the total possible recovery by the insured"). Most excess policies follow the form of the primary policy, and provide that the insurer will be liable in excess of: (a) "[t]he total amount of all limits of liability of applicable underlying insurance; or (b) "[a]s respects any claim or suit to which no underlying insurance applies, the greater of either: (1) [t]he applicable limit or limits of liability or any other valid and collectible insurance available to the insured, or (2) [t]he amount stated in Item 4 of the declarations as the retained limit."

As may be understood from review of the above, umbrella coverage may extend to risks much greater than a conventional excess policy. *See* Thomas W. Johnson, Jr., *Identifying and Using Insurance Coverage in Business Litigation*, 74 (March 1991) (discussing different features of excess and umbrella policies). Sometimes, even when primary coverage is unavailable, an umbrella policy may provide protection from certain losses. *See Aetna Casualty & Surety Co., Inc. v. Centennial Ins. Co.*, 838 F. 2d 346, 350-51 (9th Cir. 1988) (discussing facts in which the umbrella carriers' coverage was broader than the primary carriers' coverage).

The effect of an umbrella policy is also different from that of an excess policy when a primary policy's "other insurance" clause becomes applicable. In contrast to an excess policy, a "true" umbrella policy is not subject to a determination pursuant to the "other insurance" clause regarding how coverage shall be allocated among two or more policies that apply to the same insured and risk. *Continental Ins. Co. v. Lexington Ins. Co.*, 55 Cal. App. 4th 637, 643 (Cal. Ct. App. 2d 1997) (discussing two equally applicable primary policies, and not a triggered umbrella policy, were properly prorated to cover the loss).

Further, umbrella policies differ from true excess policies because they are usually triggered either by exhaustion of primary coverage or payment of

the self-insured retention. *FMC Corp. v. Plaisted & Cos.*, 61 Cal. App. 4th 1132, 1190 (Cal. Ct. App. 6th 1998).

D. Self-Insured Retentions and Deductibles

A self-insured retention allows the insured to act as his own primary insurer. Insurance policies subject to self-insured retentions are considered implied excess insurance. The court, in *Pacific Employers Ins. Co. v. Domino's Pizza, Inc.*, 144 F. 3d 1270, 1276-77 (9th Cir. 1998), stated: "It is well recognized that self-insurance retentions are the equivalent to primary liability insurance, and that policies which are subject to self-insured retentions are 'excess policies' which have no duty to indemnify until the self-insured retention is exhausted."

Pursuant to most self-insured retentions, the insured must actually pay the specified retention amount before excess coverage is triggered. *Vons Cos., Inc. v. United States Fire Ins. Co.*, 78 Cal. App. 4th 52, 62 (Cal. Ct. App. 2d 2000). However, depending on the language of the applicable insurance policy, payment of the retention may be accomplished by an insured's other insurance. *Id.*

A deductible is quite different from a self-insured retention. Generally, a deductible need not be paid before an insurer defends and indemnifies or excess insurance becomes applicable. D.W. Duke, California Insurance Issues and Forms, § 8:50.20 (1st Ed. 2003). In many of these policies, the deductible only applies to losses arising from actual indemnification of third parties. *Id.* Provided that the policy includes a duty to defend, the insurer is responsible for furnishing a defense before the deductible is paid. *Id.* Often, insurance companies pay the deductible amount subject to insured reimbursement or subrogation of recovery proceeds.

III. Trigger for Duties to Defend and Indemnify: Exhaustion

Review of the excess policy language itself is the starting-point for determining what duties an excess carrier owes the insured. However, usually, the extent of an excess insurer's obligations are to defend and indemnify upon the happening of events specified in the policy. See, e.g., *Hartford Acc. & Indem. Co. v. Continental Nat'l American Ins. Cos.*, 861 F. 2d 1184, 1186 (9th Cir. 1988); *Signal Cos. V. Harbor Ins. Co.*, 27 Cal. 3d 359, 366 (Cal. 1980). *See also* Thomas W. Johnson, Jr., *Identifying and Using Insurance Coverage in Business Litigation*, 74 (March 1991) (stating "[a]n excess insurer has no obligation to defend a claim until the primary limits have been exhausted by payment of judgments or settlements."). The following discusses the components of the an excess insurer's duties to defend and indemnify.

A. Duty to Defend

1. Existence of Defense Duty

To determine whether a duty to defend exists, you examine applicable excess policy language. Many of the excess policies you will review unequivocally exclude any defense obligation – they construe defense as the sole obligation of the primary insurer. Dennis Wall, *Litigation & Prevention of Insurer Bad Faith*, 2d Ed. § 6:3 (July 2003). Other policies are not so clear. When excess policy language is ambiguous, an "equitable" duty to defend is implied and owed. *Aetna Cas. & Sur. Co. v. Certain Underwriters at Lloyds*, 56 Cal. App. 3d 791, 800-01 (Cal. Ct. App. 2d 1976); Thomas W. Johnson, Jr., *Identifying and Using Insurance Coverage in Business Litigation*, 74 (March 1991).

Many out-of-state courts consider California's rule harsh. They hold that "in the absence of an express statutory or contractual duty to defend, there is no such duty." *Nat'l Union Fire Ins. Co. v. Travelers Ins. Co.*, 214 F. 3d 1269, 1273 (11th Cir. 2000). *See also Allstate Ins. Co. v. RJT Enters.*, 692 So. 2d 142, 144 (Fla. 1997).

2. Extent of Defense

Some excess policies give the insurer the option of paying for its own defense counsel or reimbursing the insured for reasonable defense costs incurred with the insurer's consent on exhaustion of primary limits. *Hartford Acc. & Indem. Co. v. Continental Nat'l American Ins. Cos.*, 861 F. 2d 1184, 1186 (9th Cir. 1988); *Save Mart Supermarkets v. Underwriters at Lloyd's London*, 843 F. Supp. 597, 603 (N.D. Cal. 1994) (distinguishing between an excess insurer's duty to defend and duty to reimburse defense costs). Subject to the language of the policy, a primary insurer may discontinue defense and indemnity if its limits are actually exhausted. *Johnson v. Continental Ins. Cos.*, 202 Cal. App. 3d 477, 486 (Cal. Ct. App. 2d 1988). *See also Hartford Acc. & Indem. Co. v. Continental Nat. American*, 861 F. 2d 1184, 1186-87 (9th Cir. 1988). The same is true of an excess insurer.

B. Duty to Indemnify

If a defense duty has been discharged or satisfactorily disclaimed, an excess insurer's duty to indemnify is triggered upon exhaustion of primary insurance limits. "Exhaustion" is largely defined by law. However, excess policy language may also provide guidance. The following discusses rules for determining when "exhaustion" has occurred.

C. Definition of "Exhaustion"

California law construes "exhaustion" as payment of a judgment or settlement in an amount that exceeds the limits of the underlying policy(ies). *Signal Cos. V. Harbor Ins. Co.*, 27 Cal. 3d 359, 367 (Cal. 1980); *Chubb / Pacific*

Indem. Group v. Ins. Co. of No. America, 188 Cal. App. 3d 691, 697-98 (Cal. Ct. App. 2d 1987). *See also Phoenix Ins. Co. v. United States Fire Ins. Co.*, 189 Cal. App. 3d 1511, 1529-30 (Cal. Ct. App. 2d 1987) (holding primary coverage is "exhausted" when the primary insurers pay out their policy limits in settlement or to satisfy a judgment against the insured). "Exhaustion" does not occur if the insured or primary insurer merely tenders its limits to the excess insurer before the primary policy limits have actually been exhausted. Chubb, 188 Cal. App. 3d at 698-99; Thomas W. Johnson, Jr., *Identifying and Using Insurance Coverage in Business Litigation*, 75 (March 1991). This is true even if it is obvious that eventual settlement or judgment will exceed the primary insurer's limits. *Id.* at 698. *See also* Dennis Wall, *Litigation & Prevention of Insurer Bad Faith*, 2d Ed. § 6:3 (July 2003) (discussing no precedent for proposition that excess insurer's duties triggered in advance of payment of underlying limits). Additionally, "exhaustion" does not occur when there is only a possibility that the primary limits might be exceeded. *Signal Cos. V. Harbor Ins. Co.*, 27 Cal. 3d 359, 368 (Cal. 1980).

1. "Exhaustion" in a Continuing Loss Case

Exhaustion is easily understood when the insured has one primary policy and one excess policy. In this situation, a decision on whether exhaustion has occurred depends on whether the primary carrier has paid a judgment or settlement in excess of primary policy limits. Determining whether exhaustion occurs in a construction defect or other continuing loss case in which the insured has several applicable primary policies, however, is much more difficult. The analysis in this situation depends on understanding excess policy language concerning: (1) triggers relating to the condition of the applicable primary policies; and (2) triggers relating to the exhaustion status of specific underlying insurance.

a. Triggers Relating To The Condition Of The Applicable Primary Policies

Many excess policies provide that they are "aggregate" or "catastrophe" excess to underlying insurance. "Aggregate" excess coverage is triggered when the underlying aggregate limits of each applicable underlying policy are reached. "Catastrophe" excess coverage begins when the "per occurrence" limits of each applicable underlying policy have been exhausted.

b. Triggers Relating To The Exhaustion Status Of Specific Underlying Insurance

(1) "Specific Excess" and "Vertical Exhaustion"

You will recall that a "specific excess" policy is triggered when the coverage of a specifically identified primary policy is exhausted. *Olympic Ins. Co. v. Employers Surplus Lines Ins.*, 126 Cal. App. 3d 593, 598 (Cal. Ct. App. 1st 1981). When multiple primary policies cover an insured for the same claim and the applicable excess policy is of the "specific excess" type, "vertical exhaustion" can occur. A simple example of this doctrine is when an insured

has a $100,000 primary policy from Insurer A. The insured has a "specific excess" policy from Insurer B tied to Insurer A's primary policy with limits of $2 million. The insured is also covered for the same loss by a $1 million primary policy from Insurer C. Assume defense counsel for Insurer A negotiates a reasonable settlement of a claim in the amount of $500,000. Insurer C has no indemnification liability in this example notwithstanding its additional primary policy. That is because Insurer B's policy automatically and contractually "kicked in" before Insurer C's policy could apply. *See Community Redev. Agency v. Aetna Cas. & Sur. Co.*, 50 Cal. App. 4th 329, 339-40 (Cal. Ct. App. 2d 1996) (discussing "vertical" and "horizontal" exhaustion rules).

(2) "Broad as Primary" and "Horizontal Exhaustion"

A "broad as primary" excess policy covers "a loss which is covered under the policies of underlying insurance." *Housing Group v. California Ins. Guar. Ass'n*, 47 Cal. App. 4th 528, 531 (Cal. Ct. App. 4th 1996). When an excess policy does not specifically identify a particular underlying coverage, all primary policy limits for a given year must be exhausted before excess coverage attaches. *Olympic*, 126 Cal. App. 3d at 600. This is the "horizontal exhaustion" rule. Changing the hypothetical of the above paragraph so that Insurer B had a "broad as primary" policy instead of a "specific excess" policy, Insurer C's indemnity obligation would amount to $400,000. Because the indemnity obligation of the excess policy would only be triggered by exhaustion of all "underlying insurance," Insurer B would have no indemnity responsibility. See *Community Redev. Agency*, 50 Cal. App. 4th at 340; *Iolab Corp. v. Seaboard Sur. Co.*, 15 F. 3d 1500, 1505 (9th Cir. 1994) (discussing "horizontal" exhaustion).

2. Insolvency As "Exhaustion"

In general, insolvency of a primary carrier is not commensurate with "exhaustion" – "drop down" analysis, described below, is required. An exception to this rule is when excess policy language includes insolvency in the definition of "exhaustion."

3. Mixture of "Specific Excess" and "Broad as Primary" Policies Over Multiple Policy Periods

Insurance professionals often ask, "What if you have a case in which there are several applicable primary policies and excess policies with both "specific excess" and "broad as primary" language? How do allocate respective defense and indemnity responsibilities?" The answer is that there is no bright-line rule. An insurance professional should consult an attorney. The first thing the attorney will do is analyze the language of all applicable primary and excess policies for each year. She will require a status of the condition all applicable primary policies. In the excess policies, she will look for any language specifically describing triggers of excess insurance coverage. If she finds the language, she will apply the "vertical" and "horizontal" exhaustion rules as applicable for each policy year. If, in a given year, no language exists

or it is ambiguous, the best course is apply the “horizontal exhaustion” rule for that year. This method is consistent with the rationale and principles pronounced in *Montrose Chemical Corp. v. Admiral Ins. Co.*, 10 Cal. 4th 645, 687-88 (Cal. 1995) (describing policy considerations leading Court to adopt the continuous injury trigger of coverage for the third party claims of continuous or progressively deteriorating damage or injury).

IV. The “Drop Down” Principle

As more and more sue, less and less coverage becomes available. While “exhaustion” is often a cause of insurance unavailability, in recent years, increased insurer insolvency and refusal to defend has greatly contributed to lack of coverage. When these situations occur, excess carriers grapple with the decision of whether or not to “drop down.” An excess insurer “drops down” when it assumes defense and indemnity obligations of the underlying insurer(s). *Se*e Dennis Wall, *Litigation & Prevention of Insurer Bad Faith*, 2d Ed. § 6:3 (July 2003) (discussing “drop down” duty).

Determining whether to “drop down” is a three-step process. First, the excess carrier must decide whether a “drop down” trigger is presented. Second, assuming a trigger is present, the excess insurer must analyze whether “dropping down” is required. Finally, if no “drop down” duty is owed, the excess carrier must decide on whether “dropping down” is advisable.

A. The “Drop Down” Triggers

1. Underlying Insurer Insolvency

Depending on the excess policy’s language, insolvency of the primary carrier may give rise to the “drop down” duty. *Reserve Ins. Co. v. Pisciotta*, 30 Cal. 3d 800, 812 (Cal. 1982) is the seminal case on whether excess policy language includes a duty to “drop down.” The verbiage at issue there was: “The Company [CNA] shall only be liable for the ultimate net loss in excess of either: . . . the *amount recoverable* under the underlying insurance as set out in the schedule of underlying insurance . . . .” (emphasis added). As a part of their analysis of whether this language gave rise to a “drop down” duty, the Supreme Court reasoned that:

> That language might possibly be interpreted either to expose CNA only for amounts over the dollar limits of the underlying insurance or to expose CNA for amounts which the insured is not able to actually recover from the underlying insurer because of its insolvency. Because there are two meanings which may reasonably be attributed to the term in question, it is ambiguous and under settled principles must be construed in favor of the insured. Reserve is now insolvent, so the "amount recoverable " from Reserve is something substantially less than the Reserve

> policy limit of $100,000. We therefore conclude that the CNA policy includes the risk of Reserve's insolvency within the scope of its coverage.

Pisciotta, 30 Cal. 3d at 815.

The Court's rationale in *Pisciotta* was that if CNA was liable for amounts that could not be recovered, insolvency is a reason why amounts may not be recovered, and no language specifically excludes a "drop down" obligation on underlying insurer insolvency, the policy must require CNA to "drop down" upon Reserve's insolvency. Since this holding, courts acknowledge that underlying insurer insolvency is a potential trigger of the duty to "drop down."

a. Excess Insurer's Duty to Inquire

The court in *Span, Inc. v. Associated Int'l Ins. Co.*, 227 Cal. App. 3d 463, 483 (Cal. Ct. App. 2d 1991) held that an excess insurer, who has notice of the insolvency of an insured's primary insurer, is on inquiry notice of the underlying claim because the "ordinary presumption that the primary insurer will 'provide an experienced defense'" does not apply when the excess insurer knows about the insolvency of the primary insurer. The interesting point about this case was that the excess policy's language was not phrased like CNA policy in *Pisciotta* – it expressly precluded any obligation to "drop down" upon primary carrier insolvency. The holding may indicate that, in the future, excess carriers have a duty to inquire into a claim against an insured any time they know that the insured's primary carrier may become insolvent. Whether this rule will lead future courts to recognize an equitable defense and/or indemnity obligation on behalf of excess insurers who contracted with insureds with insolvent primary carriers is anybody's guess.

2. Underlying Insurer Refusal to Defend

Whether or not underlying insurer refusal to defend triggers the obligation to "drop down" depends on the language of the excess policy. *Ticor Title Ins. Co. v. Employer Ins. Of Wausau*, 40 Cal. App. 4th 1699, 1708-09 (Cal. Ct. App. 1st 1995). No California court has held that, notwithstanding policy provisions, the excess carrier has a duty to defend when the primary carrier refuses and the amount of the claim approaches or exceeds the primary limits. *Id.* at 1708. And it seems unlikely that such decisions are forthcoming given California courts' firm insistence that actual exhaustion is the trigger of an excess insurer's obligations. *See Republic Western Ins. Co. v. Fireman's Fund Ins. Co.*, 241 F. Supp. 2d 1090, 1096 (N.D. Cal. 2003) (holding that "an excess insurer has no duty to defend where the primary insurer refused the tender of defense"). *See also Chubb / Pacific Indem. Group v. Ins. Co. of No. America*, 188 Cal. App. 3d 691, 697-98 (Cal. Ct. App. 2d 1987); *Phoenix Ins. Co. v. United States Fire Ins. Co.*, 189 Cal. App. 3d 1511, 1529-30 (Cal. Ct. App. 2d 1987). California law on this point is in harmony with the decisions of out-of-state courts. *See American Motorists Ins. Co. v. Trane Co.*, 544 F. Supp. 669, 692

(W.D. Wisc. 1982) (holding that primary insurer refusal to defend obligates the excess carrier to "drop down" only when insured shows excess policy covers claim and claim is beyond primay policy limits); *Schulman Inv. Co. v. Olin Corp.*, 514 F. Supp. 572, 576-77 (S.D.N.Y. 1981) (holding that, without showing that claims fell outside primary policy limits, excess carrier had no duty to defend upon primary insurer's refusal).

B. Whether "Dropping Down" Is Required

The next step in the process is to analyze whether policy language requires the excess carrier to "drop down." *Reserve Ins. Co. v. Pisciotta*, 30 Cal. 3d 800, 815 (Cal. 1982); *Nat'l Union Fire Ins. Co. v. Travelers Ins. Co.*, 214 F. 3d 1269, 1273 (11th Cir. 2000). *Pisciotta* is the watershed California case on excess policy language interpretation. There, the Supreme Court held that the duty to "drop down" is non-existent if the excess insurer's policy language clearly and unambiguously excludes any duty to "drop down" in the absence of underlying coverage. If the policy language is ambiguous, however, the duty to "drop down" is implied and owed. *Pisciotta*, 30 Cal. 3d at 814-15. As you will recall, the *Pisciotta* court concluded CNA's policy language was capable of two reasonable constructions and did not expressly preclude the "drop down" duty. *Pisciotta*, 30 Cal. 3d at 815. Therefore, CNA was obligated to defend. *Id.*

This rule differs from those in other states. *See Continental Marble & Granite Co. v. Canal Ins. Co.*, 785 F. 2d 1258, 1259 (5th Cir. 1986); *Maricopa County v. Federal Ins. Co.*, 757 P. 2d 112, 114 (Ariz Ct. App. 2d 1988). Several courts outside of California share the belief that implying the "drop down" duty on excess carriers, who do not expressly exclude it from their policies, creates an unworkable financial burden.

The *Continental Marble* Court faced the issue of whether or not an excess insurer, Canal Insurance Company, was obligated to defend and indemnify the insured, Continental Marble, against claims made against it when its primary insurer became insolvent. After reviewing Canal's ambiguous policy language regarding the "drop down" duty, the Court decided no such obligation was required. It held that ambiguous policy language does not give rise to an implied duty to "drop down," and stated:

> Imposing the duty of indemnification on Canal would, in effect, transmogrify the policy into one guaranteeing the solvency of whatever primary insurer the insured might choose. An excess liability insurer obviously does not anticipate this heavy onus. Excess or secondary coverage is coverage whereby, under the terms of the policy, liability attaches only after a predetermined amount of primary coverage has been exhausted. A second insurer thus greatly reduces his risk of loss. This reduced risk is reflected in the cost of the policy.

> Continental Marble's proposed rule would require insurance companies to scrutinize one another's financial wellbeing before issuing secondary policies. The insurance world is complex enough; to impose this additional burden on companies such as Canal would only further our legal system's lamentable trend of complicating commercial relationships and transactions.

Continental Marble, 785 F. 2d at 1259 (citations omitted).

Assuming, however, you are faced with determining whether excess policy "drop down" is required in a *Pisciotta* jurisdiction, the key inquiry is whether excess policy language on the duty to "drop down" is "clear and unambiguous."

1. Determining Whether Excess Policy Language Is "Clear and Unambiguous"

Despite the Supreme Court's unequivocal pronouncement that only clear and unambiguous policy language excluding any duty to "drop down" dispossesses the excess carrier of a "drop down" obligation, much litigation centers on the issue of whether an excess carrier clearly and unambiguously excluded any duty to "drop down." The following examines case holdings on both clear and ambiguous "drop down" language.

a. Specific Language Disclaiming "Drop Down" Duty

The area of the excess policy that courts usually examine to find "drop down" language is the "limits of liability" section. Note, however, that specific language designed to avoid a "drop down" duty may also be found in an excess policy's endorsement.

Prudent excess insurers include in the "limits of liability" section language stating that liability of the excess insurer "only attaches after the underlying insurers have paid or have been held liable to pay the full amount of their respective liability." Most out-of-state courts examining similar language have determined any duty to "drop down" is not triggered. *See Hudson Ins. Co. v. Gelman Sciences, Inc.*, 706 F. Supp. 25, 28 (N.D. Ill. 1989); *United States Fire Ins. Co. v. Coleman*, 754 S.W. 2d 941, 944 (Mo. App. E.D. 1988); *American Reinsurance Co. v. SGB Universal Builders Supply, Inc.*, 532 N.Y.S. 2d 712, 716 (N.Y. Sup. Ct. 1988).

California courts seem to be in agreement. In *Span, Inc. v. Associated Int'l Ins. Co.*, 227 Cal. App. 3d 463, 476 (Cal. Ct. App. 2d 1991), the court was required to determine whether a duty to "drop down" was triggered by an Associated policy's "limits of liability" section. The clause provided that excess coverage would not apply "unless and until the insured, or the insured's underlying insurer, shall have paid the amount of the underlying limits." *Span*, 227 Cal. App. 3d at 476 n.7. Because this language evidenced a clear and

unambiguous intention on behalf of the excess insurer to disclaim a "drop down" duty, the court found no such duty owed. *Id.* at 476. *See also Denny's, Inc. v. Chicago Ins. Co.*, 234 Cal. App. 3d 1786, 1794 (Cal. Ct. App. 2d 1991) (holding that excess policy language providing that coverage would only attach after the underlying insurers "have paid or have been held liable to pay" did not give rise to a "drop down" duty). *Accord Wells Fargo Bank v. California Ins. Guarantee Assn.*, 38 Cal. App. 4th 936, 944 (Cal. Ct. App. 1st 1995).

b. Unclear and Ambiguous "Drop Down" Duty Language

Excess policies that lack language similar to that described above can be troublesome. Complete analysis of whether to "drop down" requires insurance professionals to examine all portions of the excess insurance agreement, taking into account the circumstances of the case at hand, and applying general rules of contract interpretation. Comparison of excess policy wording to wording of policy language defined by courts is the next step. California courts in years past have provided us with certain guideposts for identifying certain per se ambiguous excess policy language.

(1) "Amount Recoverable"

The court in *Coca Cola Bottling Co. v. Columbia Cas. Ins. Co.*, 11 Cal. App. 4th 1176, 1187 (Cal. Ct. App. 4th 1992) followed the *Pisciotta* decision and confirmed that "amount recoverable" language is per se ambiguous.

Out-of-state courts are split on whether "amount recoverable" language automatically gives rise to a "drop down" duty. *See Zurich Ins. Co. Heil Co.*, 815 F. 2d 1122, 1125 (7th Cir. 1987) (examining "limits of liability" language in conjunction with "maintenance clause" language and finding no "drop down" duty); *Donald B. MacNeal, Inc. v. Interstate Fire & Cas. Co.*, 477 N.E. 2d 1322, 1325 (Ill. Ct. App. 1st 1985) (adopting the reasoning of *Pisciotta* and holding that "amount recoverable" language was ambiguous). *See also Radiator Specialty Co. v. First State Ins. Co.*, 651 F. Supp. 439, 441-42 (W.D. N.C. 1987) (considering meaning of "amount recoverable" as it was presented in the excess policy's declaration page and finding no duty to "drop down."

(2) "Exhaustion of Underlying Insurance"

As stated above, before excess coverage is triggered "exhaustion" of the primary insurance must occur. Thus, the "limits of liability" section of many excess policies contain the requirement of "exhaustion of underlying insurance." It has been argued that the definition of "exhaustion" does not include primary insurer insolvency. No California or out-of-state court has accepted or rejected the argument. *See Wells Fargo Bank, N.A. v. California Ins. Guar. Ass'n.*, 38 Cal. App. 4th 936, 945-46 (Cal. Ct. App. 1st 1995); Zurich Ins. Co. Heil Co., 815 F. 2d 1122, 1125 (7th Cir. 1987); Radiator Specialty Co. v. First State Ins. Co., 651 F. Supp. 439, 441-42 (W.D. N.C. 1987);

(3) "Covered"

The insurance involved in *Housing Group v. California Ins. Guar. Ass'n*, 47 Cal. App. 4th 528, 533 (Cal. Ct. App. 4th 1996) was an umbrella policy that had a "broad as primary" endorsement. The endorsement provided coverage for a loss "covered" under the policies of underlying insurance. The court found that "covered" could mean falling with the scope of the underlying policy or actually paid by the underlying policy. *Id.* at 532-33. Therefore, the "covered" language was ambiguous – nothing in the excess policy expressly stated coverage of the umbrella was only triggered when a loss was actually paid. The court decided the umbrella carrier was obligated to "drop down."

(4) "Maintenance of Underlying Insurance" Clause

Within the "Conditions" section of an excess policy, one can usually find a "maintenance clause." The maintenance clause requires the insured to maintain the primary insurance that is listed in the excess policy's schedule of underlying policies or to replace the listed policies with no more restrictive primary policies. Failure to maintain the primary coverage does not invalidate the excess coverage, but in the event a claim triggers excess coverage, the excess carrier can be found liable only to the extent it would have been, had the insured maintained the required primary insurance.

The practical result of an insured's failure to maintain listed primary coverage is that the excess coverage becomes unavailable to respond to a claim below the excess insurer's limit. *See* Dennis Wall, *Litigation & Prevention of Insurer Bad Faith*, 2d Ed. § 6:3 (July 2003) (discussing consequences of insured's breach of the maintenance clause). In *Zurich Ins. Co. Heil Co.*, 815 F. 2d 1122, 1125 (7th Cir. 1987), the court held that failure to heed the maintenance clause precluded a "drop down" duty, despite ambiguous "limits of liability" language in the policy. No California courts have addressed the maintenance requirement when determining whether an excess insurer must "drop down."

c. Out-of-State Analysis of "Drop Down" Question

In determining whether an excess insurer has a duty to "drop down," some out-of-state courts have looked to the implied purpose of the excess policy instead of the actual policy language. The court, in *Radiator Specialty Co. v. First State Ins. Co.*, 651 F. Supp. 439, 442 (W.D.N.C. 1987), reasoned that holding an excess insurer liable for an insolvent primary insurer's obligations would frustrate the purpose of the excess insurer's agreement to furnish secondary insurance. It decided that because the excess insurer had not bargained for the duty to pay for primary insurer responsibilities, no "drop down" duty was owed.

C. Advisability of Voluntarily "Dropping Down"

If it is clear no "drop down" duty is owed, many insurance professionals may be tempted to deny coverage. After all, why should the excess insurer "shell out" money for a defense when the trigger for coverage is actual

exhaustion? Well, the answer may be, ***to save money***. In the long run, the excess insurer may benefit financially by assuming the defense in order to control the litigation and protect the insured. By having capable defense counsel defend against the claim (instead of possibly the insured by himself), the claim is more likely to be defeated or at least contained within primary policy limits. After the claim is resolved, the excess insurer may seek equitable recovery of its expenditures from the primary insurer and/or the insured. Even if an excess insurer's duty to "drop down" is unclear, it may be advisable to accept the defense to eliminate costs associated with defending against an insured's breach of contract and "bad faith" action at a later date.

Excess insurers are cautioned, however, that if they defend when their duty to defend is unclear, they must immediately advise the insured in writing that they are defending the action solely because the primary insurer has refused to defend, not because they are obligated to do so. The insured should also be advised that the excess insurer is not volunteering the defense and that it will seek reimbursement from primary insurer. *See Phoenix Ins. Co. v. United States Fire Ins. Co.*, 189 Cal. App. 3d 1511, 1527-28 (Cal. Ct. App. 2d 1987) (holding that "an excess insurer can sue a primary insurer for the failure of the primary to defend or settle"); *National American Ins. Co. v. Ins. Co. of North America*, 74 Cal. App. 3d 565, 576 (Cal. Ct. App. 1st 1977). To be sure, failure to give such written notice will be introduced in evidence by the primary insurer as a defense to the excess insurer's subrogation action. As a back-up for the written notice, excess insurers should file a declaratory relief action against the primary insurer to determine their obligation to defend.

IV. Effects of Primary Carrier "Exhaustion" and "Drop Down" Triggers on Additional Insured Carriers

A. What Is an Additional Insured Endorsement ("AIE")?

Typically, subcontractors on construction projects are required to procure additional insured endorsements ("AIEs") in favor of the general contractor. Many landowners also make this demand of general or prime contractors. An AIE bestows on the additional insured ("AI") the same rights and obligations as the named insured on a given policy. *Presley Homes, Inc. v. American States Ins. Co.*, 90 Cal. App. 4th 571, 576 (Cal. Ct. App. 4th 2001). For all purposes, an AI is one of the named insureds, despite not having paid a premium. *Id.* Issuance of an AIE entitles both the named insured and AI to: (1) a separate evaluation of their potential liability and obligation(s) to defend; (2) the entire limits of the AI carrier's policy limits, but not more than the aggregate, and any depletions of the limits apply to both insured's equally; and (3) separate defense counsel and/or adjusters, if a potential conflict arises. Note that each insured owes a duty of cooperation with the AI insurer. *See*

William A. Nebeker and Robert C. Carlson, *Indemnity and Additional Insured Seminar*, 7 (1997).

The rationale for requiring AIEs is that today's society is litigious, and the cost of defending a lawsuit giving rise to extended vicarious liability can be enormous. Most of the time, the parties contribute in some way to the causes of the injuries and/or damages claimed. Therefore, it is appropriate to apportion the defense and indemnity costs for these lawsuits among all the parties to a particular contract. *See Maryland Casualty Co. v. Nationwide Ins. Co.*, 65 Cal. App. 4th 21, 33 (Cal. Ct. App. 4th 1998) (holding that "a key motivation in procuring an additional insured endorsement is to offset the cost of defending lawsuits where the general contractor's liability is claimed to be derivative"); *Presley*, 90 Cal. App. 4th at 577 (quoting the above portion of *Nationwide Ins. Co.*).

To comply with the AIE requirement, contractors must actually deliver the AIE to the appropriate party. Whether parties should require more documentation of an AIE is a question outside the scope of the materials. Suffice it to say that a certificate of insurance is not a contract or policy – it is merely circumstantial evidence of an AIE. *Pardee Const. Co. v. Insurance Co. of the West*, 77 Cal. App. 4th 1340, 1347 n.2 (Cal. 2000).

B. Scope of AIE Coverage

To determine the scope of an AIE, you look to its language. Two categories of AIE language exist: (1) Insurance Services Office ("ISO"); and (2) manuscripted. Because manuscripted AIEs are generally custom-made for a particular insured, their language is varied. Thus, it is difficult to generalize about such endorsements. The meanings of ISO AIE provisions, on the other hand, have been explained by both ISO and caselaw. Common features of ISO AIEs are described below.

1. ISO AIE Form Commonalities

- **Covers AI's Sole Negligence**: California Civil Code § 2782(a) voids all construction contracts in which the contractor obligates the subcontractor to indemnify it for its own *sole* negligence. Generally, this rule does not apply to currently operative AIEs. Absent AIE language to the contrary, an AI is covered for liability stemming from its own *sole* negligence and vicarious liability arising out of the named insured's negligence. *See Shell Oil Co. v. National Union Fire Ins. Co.*, 44 Cal. App. 4th 1633, 1642 (Cal. Ct. App. 2d 1996) (holding that AIE must cover AI's sole negligence, absent language to the contrary, to protect its business interests); *Chevron U.S.A., Inc. v. Bragg Crane & Rigging Co.*, 180 Cal. App. 3d 639, 646 (Cal. Ct. App. 4th 1986). *But see* 2010 – 04 AIE below.

- **Coverage May Be Present for AI Under Several Different Policies**: As is often the case in construction projects, an AI may be covered by several AIEs from different subcontractors on the job. Additionally, the AI will be a named insured on its own CGL policy. Therefore, when a claim arises, multiple insurers on the risk must share the costs of defense and indemnification. Allocation of defense and indemnification costs is discussed below.

- **AIEs Cover a AI for "Liability Arising Out Of"**: It is generally the case that ISO AIEs cover an AI for liability "arising out of" the named insured's work, operations, or premises (or some variation on this theme). The following are examples of "arising out of" language in actual ISO AIEs.

ISO SCHEDULED ADDITIONAL INSURED ENDORSEMENT LANGUAGE ("2010" - 97)*

SCHEDULE

Name of Person or Organization:

Corzine General Contractors, Inc.

Who Is An Insured (Section II) is amended to include as an insured the person or organization shown in the Schedule, but only with respect to liability arising out of your ongoing operations performed for that insured.

*This example contains an excerpt of the endorsement language, not an exact reproduction.

Source: CG 20 10 03 97, Copyright, Insurance Services Office, Inc., 1996

ISO SCHEDULED ADDITIONAL INSURED ENDORSEMENT LANGUAGE (“2009” - 97)

SCHEDULE

Name of Person or Organization:

Corzine General Contractors, Inc.

Who Is An Insured (Section II) is amended to include as an insured the person or organization (called "additional insured") shown in the Schedule but only with respect to liability arising out of:

1. Your ongoing operations performed for the additional insured(s) at the location designated above; or

2. Acts or omissions of the additional insured(s) in connection with their general supervision of such operations. ...

3. Additional Exclusions This insurance does not apply to:

a. "Bodily injury" or "property damage" for which the additional insured(s) are obligated to pay damages by reason of the assumption of liability in a contract or agreement. This exclusion does not apply to liability for damages that the additional insured(s) would have in the absence of the contract or agreement.

b. "Bodily injury" or "property damage" occurring after:

i. All work, including materials, parts or equipment furnished in connection with such work, on the project (other than service, maintenance or repairs) to be performed by or on behalf of the additional insured(s) at the site of the completed operations has been completed; or

ii. That portion of "your work" out of which the injury or damage arises has been put to its intended use ...

c. "Bodily injury" or "property damage" arising out of any act or omission of the additional insured(s) or any of their "employees" other than general supervision by the additional insured(s) of your ongoing operations performed for the additional insured(s).

d. "Property damage" to:

i. Property owned, used or occupied by or rented to the additional insured(s);

ii. Property in the care, custody or control of the additional insured(s) or over which the additional insured(s) are for any purpose exercising physical control; or

iii. Any work, including materials, parts or equipment furnished in connection with such work, which is performed for the additional insured(s) by you. *Source:* CG 20 10 03 97, Copyright, Insurance Services Office, Inc., 1996

ISO AUTOMATIC ADDITIONAL INSURED ENDORSEMENT LANGUAGE ("2010" – 97BI)*

A. Section II—Who Is An Insured is amended to include as an insured ***any person or organization for whom you are performing operations when you and such person or organization have agreed in writing in a contract or agreement that such person or organization be added as an additional insured on your policy.*** Such person or organization is an additional insured only with respect to liability arising out of your ongoing operations performed for that insured. ***A person's or organizations status as an insured under this endorsement ends when your operations for that insured are completed.*** [Emphasis added.]

*An additional exclusion, which eliminates coverage for professional design services, is not reproduced here.

Source: CG 20 10 03 97, Copyright, Insurance Services Office, Inc., 1996

ISO SCHEDULED ADDITIONAL INSURED ENDORSEMENT LANGUAGE ("2010" – 04)

A. Section II—Who Is An Insured is amended to include as an additional insured the person(s) or organization(s) shown in the Schedule, but only with respect to liability for "bodily injury", "property damage" or "personal and advertising injury" caused, in whole or in part, by:

1. Your acts or ommissions; or

2. The acts or omissions of those acting on your behalf;

in the performance of your ongoing operations for the additional insured(s) at the location(s) designated above. There is no coverage for the additional insured for "bodily injury", "property damage" or "personal and advertising injury" arising out of the sole negligence of the additional insured or by those acting on behalf of the additional insured.

B. With respect to the insurance afforded to these additional insureds, the following additional exclusion applies:

This insurance does not apply to "bodily injury" or "property damage" occurring after:

1. All work, including materials, parts or equipment furnished in connection with

such work, on the project (other than service, maintenance or repairs) to be performed by or on behalf of the additional insured(s) at the location of the covered operations has been completed; or

2. That portion of "your work" out of which the injury or damage arises has been put to its intended use by any person or organization other than another contractor or subcontractor engaged in performing operations for a principal as a part of the same project.

Source: CG 20 10 06 04, Copyright, Insurance Services Office, Inc., 2004

- **Interpretation of "Arising Out of" Language**: Some courts construe this language to include both vicarious liability for the named insured's negligent performance of work and direct liability for the AI's independent negligence. *Acceptance Ins. Co. v. Syufy Enterprises*, 69 Cal. App. 4th 321, 322-23 (Cal. Ct. App. 2d 1999). Other courts hold that the phraseology is ambiguous – it could be interpreted to mean coverage extends to either claims arising while the named insured was doing work on the AI's premises or claims arising at least in part from the insured's actual performance of work. *St. Paul Fire and Marine Ins. Co. v. American Dynasty Surplus*, 101 Cal. App. 4th 1038, 1056 (Cal. Ct. App. 2d 2002). To predict how a court would rule on interpretation of the "arising out of" language, practitioners should determine whether depriving an AI of coverage is consistent with its objectively reasonable expectations by considering policy language in the context of its intended function. *Id.* at 1058.

- **Coverage Is Triggered Even if the AI Caused the Injury or Damage**: AI coverage comes into being without regard to whether the damages were caused by the named insured or AI, so long as the AIE does not restrict coverage to fault. *Vitton Const. Co. v. Pacific Ins. Co.*, 2 Cal. Rptr. 3d 1, 6 (Cal. Ct. App. 1st 2003).

- **AI Carrier Has Duty to Defend Both Covered and Non-Covered Claims:** Because an insurer's duty to defend is broader than its duty to indemnify, it must pay for the defense of claims against the AI that may not arise out of the named insurer's work. *Maryland Casualty Co. v. Nationwide Ins. Co.*, 65 Cal. App. 4th 21, 31-32 (Cal. Ct. App. 4th 1998).

- **AI "Completed Operations" Coverage:** The "completed operations" provision of a CGL policy generally extends to liability for bodily injury or property damage that arises out of the insured's completed work. An example of a covered situation would be where a contractor, after completing construction on a building, is sued because someone was injured as the result of the building toppling. The question insurance professionals often face is whether or not the

AIE covers an AI's "completed operations." ISO 2010 – 86 covered an AI's damages resulting from an AI's "completed operations." ISO 2010 – 97 restricts coverage to only the named insured's "completed operations." ISO 2010 – 04 provides that an AI is not covered for any "completed operations" coverage whether damages arise from the completed operations of the named insured or additional insured.

- **Named Insured's Failure to Procure AIE Per Contract**: Should a named insured be obligated to obtain AI coverage pursuant to an agreement and fail to do so, it is liable personally. *See Chevron U.S.A., Inc. v. Bragg Crane & Rigging Co.*, 180 Cal. App. 3d 639, 646 n.8 (Cal. Ct. App. 4th 1986). *See also Lulich v. Sherwin-Williams Co.*, 799 F. Supp. 64, 69 (N.D. Ill. 1992) (holding "'a person breaching an agreement to obtain liability insurance is liable for all resulting damages including the amount of judgments against the promisee and the costs of defense'"). However, if the AI's own insurance pays the loss, then no claim against the named insured is available. *Patent Scaffolding Co. v. William Simpson Const. Co.*, 256 Cal. App. 2d 506, 510 (Cal. Ct. App. 2d 1967).

- **AIE Relationship with Indemnity Agreement**: Insurance law is confusing because many ambiguities result from applicable and overlapping contract provisions and law. No where in insurance law is this more true than in the relationship between the AIEs and express indemnity agreements. Many question whether the duty to indemnify stems from the AIE or the indemnity agreement or vice versa. Others ask, "If the general contractor has a strong indemnity agreement, must the AI carrier defend?" The broad answer to these questions is that the indemnity agreement does not "trump" the AIE. Insurance from any source, AI carrier or personal insurance, does not become excess to the subcontractor's obligations under the indemnity agreement. Thus, indemnity agreements mostly come into play when no AIEs exist or an AI faces liability above his own insurance (primary and excess) and his limits on the AI policy(ies).

C. Apportionment of Responsibility for Defense and Indemnity Costs Among Primary, AI, and Excess Insurers

Often in construction defect cases, an insured has many different policies that cover a continuing loss. Each policy may be held by a different carrier or be on a different "level" of coverage[1]. Ultimately, apportionment of defense and indemnity costs in construction defect cases depends on the types

[1] A coverage's "level" may be primary or excess. AIEs are primary coverage. On the diagram above, the light gray color signifies primary level coverages and the darker gray signifies excess level coverages.

of "other insurance" clauses in the coverage within a given level. *Commerce & Industry Ins. Co. v. Chubb Custom Ins. Co.*, 75 Cal. App. 4th 739, 743-44 (Cal. Ct. App. 1st 1999). However, most of the time, the language of "other insurance" clauses within a given level conflict or provide the insured with no coverage. Therefore, in almost every case, insurers on a given level are liable only for their pro rata share of the loss. *Dart Industries, Inc. v. Commercial Union Ins. Co.*, 28 Cal. 4th 1059, 1080 (Cal. 2002). Below is an example of a insurance coverage spreadsheet. Under each year heading, it shows the insurer's name and total policy limits. Under each "Balance" heading are amounts currently available for each policy to satisfy a loss within the policy.

Corzine General Contractors, Inc.

	2002	Balance	2003	Balance	2004	Balance
Primary	1. CI Ins. - $1m	$0.5m	1. NA Ins. - $2m	$0.0m	1. LG Ins. - $2m	$2m
Additional Ins.	2. LM Ins. - $2m	$0.7m	2. PO Ins. - $2m	$2m	2. LM Ins. - $2m	$2m
	3. NA Ins. - $1m	$1m	3. TY Ins. - $2m	$0.10	3. TY Ins. - $2m	$1.80
	4. PA Ins. - $2m	$2m	4. LM Ins. - $2m	$2m	4. LM Ins. - $2m	$2m
Excess	5. UI Ins. - $5m	$5m	5. UI Ins. - $5m	$1.70	5. UI Ins. - $5m	$5m
	6. QD Ins. - $5m	$5m	5. QD Ins. - $5m	$5m	6. QD Ins. -$5m	$5m

1. Calculation of Pro Rata Share of Loss

To figure an insurer's pro rata share of a particular loss, you divide the insurer's policy limits by the total policy limits of all policies within a given level of coverage and within a given year. For example, look at the primary and AI policies for the year 2002 above. Assume the total loss is $5 million for that year. If you wanted to know CI Insurance's share, you would divide 1 by 6 and come up with 16.67%. You would then multiply 16.67% by $5,000,000, and the result would be $833,333.

2. Sources of Payment for the Loss: AI and Excess Carriers

While CI Insurance's share of the loss is $833,333 in the example above, it is not going to pay that much. Why? CI Insurance's policy limits are $1 million, and $500,000 has already been depleted paying other claims. The question that arises here is: "Who pays the $333,333?" The answer depends on the type of applicable excess policy trigger. As you will recall, these triggers generally fall into two categories: (1) "specific excess"; and (2) "broad as primary." If UI Insurance's excess policy is "specific excess" to the CI Insurance policy, then "vertical exhaustion" occurs. That is, CI Insurance pays $500,000 and exhausts, exhaustion automatically triggers the "specific excess" policy, and UI Insurance pays the $333,333. If the UI Insurance policy is "broad as primary," then CI Insurance pays $500,000 and exhausts, the insurance pool is re-divided because CI Insurance no longer pays, and the remaining insurers pay the remainder proportionally (i.e., LM Insurance pays 40% or $133,333, NA Insurance pays 20% or $66,667, and PA Insurance pays 40% or $133,333).

V. Notice of Claims to Excess Insurers

Assuming exhaustion has occurred, an excess carriers obligation to defend and indemnify begins upon proper and timely notice of the claim. Courts confronting the issue of whether an excess insurer has received proper notification of the underlying claim ask two questions: (a) Who gave the excess insurer notice of the claim? and (b) Was the notice proper and given within the time required?

A. Insured Notice of a Claim

The "Conditions" section of an excess insurance policy is generally the source of the obligation to notify. It usually requires notice of an occurrence reasonably likely to result in a loss that will exceed the primary insurer's policy limits. However, prudent insureds give notice of claims to all applicable primary and excess insurers at the same time.

B. Primary Insurer Notice of a Claim

Because no privity extends between primary and excess insurers, primary insurers are generally not required to put excess insurers on notice of claims likely to exceed their limits. However, it is in their best interests to do so. In the context of equitable subrogation, the primary insurer has no greater rights against the excess insurer than the insured. Therefore, if the primary insurer pays a judgment outside its policy limits and commences a subrogation action, the excess insurer may defend on the ground that the insured failed to provide timely and proper notice of the claim. If this is proved, the defense may bar the primary insurer from recovering against the excess insurer. *See Sequoia Ins. Co. v. Royal Ins. Co.*, 971 F. 2d 1385, 1393-94 (9th Cir. 1992). Also, notice to the excess insurer may assist in settlement of the claim. Should it be likely that the claim will exceed primary policy limits, a contribution from the excess insurer before it does may resolve the claim earlier.

C. Proper Notice

In determining whether notice to the excess insurer is proper, courts examine whether notice was timely and sufficient to notify the excess insurer that policy limits arte likely to be invaded.

1. Timeliness of Notice

Few California cases have had occasion to consider timeliness of notice in the context of a claim likely to implicate excess coverage. Therefore, it seems likely that the "notice-prejudice" rule that applies in bad faith cases also applies in this context. Under this rule, an excess carrier must prove "actual prejudice" to take advantage of an insured's violation of policy rules. *Shell Oil Co. v. Winterthur Swiss Ins. Co.*, 12 Cal. App. 4th 715, 761-63 (Cal. Ct. App. 1st 1993). *See also Campbell v. Allstate Ins. Co.*, 60 Cal. 2d 303, 305

(Cal. 1963); *Northwestern Title Sec. Co. v. Flack*, 6 Cal. App. 3d 134, 141 (Cal. Ct. App. 1st 1970).

VI. RESPONSE TO CLAIM EXCEEDING EXCESS POLICY LIMITS

After being timely and properly notified of a pending a claim, an excess insurer must decide how to respond. The first step in making this decision is to provide a written acknowledgement of the notification to the insured and primary insured. The second step is to determine whether the excess policy covers the claim. The final step is providing the insured (and the primary insurer) with a written response, detailing the coverage decision. If the policy clearly covers the loss, the carrier should issue an acceptance of coverage letter. If only a potential for coverage exists, a "reservation of rights" letter should be sent. Only if it is absolutely clear that no coverage is supplied by the policy, should a coverage denial letter be issued.

A. Claim Acknowledgement

Because an insured has a right to know whether or not its excess carrier is processing, or at least has received, its notice, it is prudent for an excess insurer to send the insured written acknowledgement of having received notice of the pending claim. Notice of receipt should also be sent to the primary insurer, if its identity is known or can be easily acquired. Included within the acknowledgment should be a request that the insured provide the name of the primary insurer, policy number, policy limits, the amount of policy that has been used for this claim or others, date any litigation began, the name of the court in which the case is venued, the court case number, the parties to the case and their counsel, the operative complaint, and the trial date, if any has been scheduled.

B. Coverage Is Clear

If the excess policy clearly covers the reported claim, no reservation of rights letter should be issued. The excess insurer should send a letter to the insured (and primary insurer, if known) stating that: (1) the policy covers the claim; and (2) the excess insurer will defend. It should make sure that it has adequate reserves for the claim and that the insured is presently be represented by competent counsel.

Excess insurers should also carefully contemplate what "defense" they will provide and how they will monitor and protect their own interests when coverage is clear. Hiring panel counsel may give the excess insurer greater control of the litigation. Joint retainer of defense counsel appointed by the primary insurer should be considered to avoid "getting up to speed" costs.

What is more important, however, is the decision about whether to monitor the case through in-house staff or coverage counsel. To adequately protect the interests of an excess insurer, monitoring of the case must be continuous and firm. Excess insurer attorneys must review defense counsel's pleadings, discovery, and correspondence and carefully examine its investigation and analysis. Persons charged with the duty must be experienced civil litigators within the geographic location of the claim. This is so because of the remarkable control defense counsel will retain on the amount of the settlement or judgment. For example, if defense counsel believes it is a foregone conclusion that the claim exceeds primary policy limits, he or she may not be motivated to settle the claim within primary policy limits. Coverage counsel are necessary to work jointly with defense counsel and ensure the excess insurer's voice is heard among the parties contemplating settlement. *Guiding Principles for Insurers of Primary and Excess Coverages*, ¶¶ 5, 6, 9 (1974).

C. Reservation of Rights

Excess insurers are not obligated to issue reservation of rights letters before primary policy limits are exhausted. *Phoenix Ins. Co. v. United States Fire Ins. Co.*, 189 Cal. App. 3d 1511, 1529-30 (Cal. Ct. App. 2d 1987). Just like the duty to defend and indemnify, the obligation to issue a reservation of rights letter when coverage is disputed is not triggered until actual exhaustion occurs. *Id.* at 194. *See St. Paul Fire & Marine Ins. Co. v. Children's Hosp. Nat'l Med. Center*, 670 F. Supp. 393, 402 (D.D.C. 1987). However, if primary policy limits are exhausted and coverage is ambiguous, excess insurers must send a reservation of rights letter to the insured (and to primary insurers, too). Failure to provide such letter may estop the excess insurer from raising coverage defenses or cause waiver of the defenses.

In some situations, it may be prudent to issue a reservation of rights letter even though the primary policy is not exhausted. In keeping with the saying, "All good deeds shall not go unpunished," excess carriers are often penalized for closely monitoring the underlying litigation and providing advice or information to the insured or primary insurer. In these situations, because the primary policy limits are not actually exhausted throughout the litigation, the excess insurer does not issue a reservation of rights letter. When judgment is entered above the primary policy limit, the primary insurer pays its portion of the judgment and the excess insurer issues a reservation of rights letter. The insured then tenders payment of the remainder of the judgment to the excess insurer. The excess insurer denies coverage, and the insured sues for "bad faith." In this action, the insured argues that the excess insurer, by acting as if it was defending the action, is estopped from raising coverage defenses because of its earlier involvement in the case. *See Whiting Corp. v. Home Ins. Co.*, 516 F. Supp. 643, 646 (S.D.N.Y. 1981). *But see St. Paul Fire & Marine Ins. Co. v. Children's Hosp. Nat'l Medical Center*, 670 F. Supp. 393, 402 (D.D.C. 1987). To avoid the insured succeeding with its claim for estoppel,

many excess insurers issue reservation of rights letters if coverage is unclear immediately, even if primary policy limits have not been exhausted.

However, in line with the phrase, "You're damned if you do, and damned if you don't," a excess insurer may suffer negative consequences if it sends a reservation of rights letter before primary policy limits are actually exhausted. First, it might create a rift in relations with the insured and put the insured on notice that a "bad faith" action against the excess insurer may be required. Second, a reservation of rights letter may provoke the insured to file a declaratory relief action. It is true that the action would be premature because, presumably, primary policy limits have not yet been exhausted. However, such action would require the excess insurer to defend until resolution of the coverage question or the primary policy has been exhausted.

All in all, the decision about when and/or whether to issue a reservation rights letters comes to down to a simple business decision. If waiver of coverage defenses is too costly a risk, then the reservation of rights letter should be issued immediately. If the coverage question is likely to resolve in favor of the insured, the excess insurer may desire to wait until primary policy limits are actually exhausted to issue the reservation of rights letter.

VII. SETTLEMENT OF CLAIMS EXCEEDING PRIMARY INSURANCE

Much of excess insurance litigation concerns the obligations of the insured, primary insurer, and excess insurer in resolution of the claim before judgment. The following discusses the rights and duties of these parties when settling the underlying claim.

A. Duty of Good Faith and Fair Dealing

In California, inherent in every insurance policy is the implied covenant of good faith and fair dealing. That is, neither the insurer nor the insured may commit actions to the detriment of each other. *See Crisci v. Security Ins. Co.*, 66 Cal. 2d 425, 429 (Cal. 1967); *Communale v. Traders & General Ins. Co.*, 50 Cal. 2d 654, 659 (Cal. 1958); *Transit Cas. Co. v. Spink Corp.*, 94 Cal. App. 3d 124, 131 (Cal. Ct. App. 3d 1979); *Liberty Mutual Ins. Co. v. Altfillisch Construction Co.*, 70 Cal. App. 3d 789, 797 (Cal. Ct. App. 4th 1977).

1. Insured's Duty of Good Faith and Fair Dealing to the Excess Insurer

Among an insured's obligations to an excess carrier are the following: (1) delivery of timely and proper notice of a claim likely to exceed primary policy limits; (2) maintenance of underlying insurance or replacement of the insurance with no more restrictive terms, conditions, and exclusions; (3) cooperation in investigation, discovery proceedings, and settlement of the

claim; (4) payment in full of self-insured retention or deductible; and (5) compliance with all other terms and conditions of the excess policy.

2. Excess Insurer's Duty of Good Faith and Fair Dealing to the Insured

As a component of its duty to the insured, the excess insurer must settle a claim within its policy's limits and avoid judgment against the insured for an amount in excess of those limits. *Northwestern Mutual Ins. Co. v. Farmers Ins. Group*, 76 Cal. App. 3d 1031, 1041 (Cal. Ct. App. 4th 1978); *Kelley v. British Commonwealth Ins. Co.*, 221 Cal. App. 2d 554, 562 (Cal. Ct. App. 1st 1963). When it has been notified of multiple claims that together may exceed excess policy limits, it also must work to resolve all the claims within excess policy limits to protect the insured against a personal judgment. *Schwartz v. State Farm Fire & Casualty Co.*, 88 Cal. App. 4th 1329, 1338 (Cal. Ct. App. 2d 2001).

3. Good Faith and Equitable Obligations Between the Primary and Excess Carriers

The insured has an insurance contract with both the primary and excess insurers. Generally, no contracts exists between the primary and excess carriers. However, by virtue of their contractual relationships with the insured, primary and excess insurers owe good faith and other[2] duties to each other. *Signal Cos. v. Harbor Ins. Co.*, 27 Cal. 3d 359, 369 (Cal. 1980). The extent of their obligations depends on the particular policies involved, the nature of the claims made, and the insured's relationships with the insurers. *Id.* at 369.

a. Failure to Settle Within Primary Policy Limits

The extent of primary and secondary insurers' duties to each other gets analyzed most often in the context of litigation concerning the primary insurer's failure to settle a claim within its policy limits. Excess insurers often argue that they were damaged as a result of the primary insurer's unreasonable failure to settle the underlying claim within primary policy limits. *See Continental Casualty Co. v. Royal Ins. Co.*, 219 Cal. App. 3d 111, 117-18 (Cal. Ct. App. 1st 1990); *Northwestern Mutual Ins. Co. v. Farmers Ins. Group*, 76 Cal. App. 3d 1031, 1049-50 (Cal. Ct. App. 4th 1978). Before litigation commences, excess insurers frequently resort to issuance of the "bad faith" letter. Dennis Wall, *Litigation & Prevention of Insurer Bad Faith*, 2d Ed. § 6:7 (July 2003). This letter demands that the primary insurer settle within primary policy limits or risk being sued for equitable subrogation and "bad faith." *Id.*

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[2] One such duty arises when a primary insurer makes payments above its policy's limits. Courts may require the excess insurer to contribute and/or reimburse the primary insurer to the extent the defense costs were incurred after the primary insurer's limits were exhausted. *Pacific Indemn. Co. v. Fireman's Fund Ins. Co.*, 175 Cal. App. 3d 1191, 1200-01 (Cal. Ct. App. 2d 1985); Thomas W. Johnson, Jr., *Identifying and Using Insurance Coverage in Business Litigation*, 75 (March 1991).

(1) "Bad Faith" Letter Before Settlement Occurs

Upon receipt of the letter, the primary insurer's counsel typically tells the excess carrier that he intends to settle the claim for an amount above primary policy limits. The question that often arises is: Can the excess carrier stop the settlement? This question has not been resolved by California courts. It seems doubtful, however, that an excess insurer's counsel may interfere with existing defense counsel's case and settle the claim for an amount within primary policy limits. *See Northwestern Mut. Ins. Co. v. Farmers Ins. Group*, 76 Cal. App. 3d 1031, 1041 (Cal. Ct. App. 4th 1978). It is permissible, however, for the excess insurer's counsel to step-in and settle a claim for an amount that exceeds primary policy limits. *Fortman v. Safeco Ins. Co.*, 221 Cal. App. 3d 1394, 1400-01 (Cal. Ct. App. 2d 1990).

(2) "Bad Faith" Letter After Settlement Occurs

If the primary insurer enters into an unreasonable settlement, exceeding primary policy limits, the excess carrier may sue for equitable subrogation and recover all defense and indemnity costs. *Northwestern Mut. Ins. Co. v. Farmers Ins. Group*, 76 Cal. App. 3d 1031, 1049-50 (Cal. Ct. App. 4th 1978) (holding "[i]t is settled that recoverable damages for the failure of an insurer to effect reasonable settlement within its policy limits includes the entire amount of the insured's liability to the injured claimant, even though that amount be in excess of the insurer's policy limits"); *Fortman v. Safeco Ins. Co.*, 221 Cal. App. 3d 1394, 1399-1400 (Cal. Ct. App. 2d 1990). Under this theory, the excess insurer "stands in the shoes" of the insured and is equitably subrogated to the insured's rights against the primary insurer. *Bohemia, Inc. v. Home Ins. Co.*, 725 F. 2d 506, 515 (9th Cir. 1984); *Valentine v. AETNA Ins. Co.*, 564 F. 2d 292, 297 (9th Cir. 1977).

The rationale behind equitable subrogation has three bases: (1) the insured and excess insurer share same responsibilities after primary limits are exhausted; (2) the primary insurer should not be the recipient of a windfall merely because the insured prudently procured an excess policy; and (3) recognition of an equitable subrogation action harmonizes with the public policy of reducing the incentive of a primary insurer to act in bad faith. Valentine, 564 F. 2d at 298; Stephen S. Ashley, *Bad Faith Actions: Liability and Damages* § 6:12 (West 1997).

An equitable subrogation claim exists even if the insured has not been damaged. *Northwestern Mut. Ins. Co. v. Farmers Ins. Group*, 76 Cal. App. 3d 1031, 1049-50 (Cal. Ct. App. 4th 1978). The primary insurer may not raise as a defense that the excess insurer failed to participate in the defense or monitor the primary carrier's acts. *Continental Casualty Co. v. Royal Ins. Co.*, 219 Cal. App. 3d 111, 118 (Cal. Ct. App. 1st 1990).

While the equitable subrogation cause of action gives an excess insurer leverage against the primary insurer(s), it also has its problems. The main

concern with the action is that the excess insurer, laced in the shoes of the insured, can only recover the amount the insured could have recovered against the primary insurer if the insured was prosecuting the action. *Transit Casualty Co. v. Spink Corp.*, 94 Cal. App. 3d 124, 134-35 (Cal. Ct. App. 3d 1979); *Russo v. Rochford*, 123 Misc. 2d 55, 60 (N.Y. Sup. Ct. 1984). Thus, any proven wrongful conduct on behalf of the insured offsets the excess insurer's recovery. *Spink*, 94 Cal. App. 3d at 134-35.

(3) "Triangular Reciprocity" Theory

The court in *Spink* applied the "triangular reciprocity" theory to find a direct duty of care to exist between a primary and excess carrier. It likened the insured, primary carrier, and excess carrier to three points of a triangle of good faith and fair dealing. Under this direct duty theory, the excess insurer could recover all damages proximately caused by the primary insurer's unreasonable failure to settle within policy limits without regard of the insured's wrongful acts. The only limit on the excess carrier's recovery would be its own contributory negligence. The California Supreme Court, in *Commercial Union Assurance Cos. v. Safeway Stores, Inc.*, 26 Cal. 3d 912, 921 (Cal. 1980), disapproved of a portion of the *Spink* decision. It did not, however, depublish the case or overrule application of the "triangular reciprocity" theory. Therefore, whether such theory is available against a primary insurer is currently an open question. *But see Russo v. Rochford*, 123 Misc. 2d 55, 61-62 (N.Y. Sup. Ct. 1984) (rejecting "triangular reciprocity" theory as superfluous in view of direct duties between primary and excess carriers).

(4) "Independent and Direct Duty" Theory

One New York court held that malpractice committed by the primary insurer's counsel coupled with the primary insurer's deliberate choice to forego assertion of a third party claim in the litigation, made the excess insurer, who paid the loss, "the equitable assignee or subrogee of whatever rights its assured would have" against the non-joined party "or any other responsible party[.]" *Hartford Accident & Indemn. Co. v. Michigan Mut. Ins. Co.*, 462 N.Y.S. 2d 175, 178 (N.Y. App. Div. 1983). It noted that "[a]ny such right of action arises as a result of the independent and direct duty to the excess insurer and is not dependent upon equitable principles of subrogation[.]" *Id.* No California court has acknowledged *Hartford Accident*'s holding. The out-of-state courts that have reviewed the decision have uniformly rejected and declined to extend its holding. *See Great Southwest Fire Ins. Co. v. CNA Ins. Cos.*, 547 So. 2d 1339 (La. App. 3th Cir. 1989); *Phico Ins. Co., Inc. v. Aetna Cas. & Sur. Co. of America*, 93 F. Supp. 2d 982 (S.D. Ind. 2000); *Rabouin v. Metropolitan Life Ins. Co.*, 182 Misc. 2d 632 (N.Y. Sup. Ct. 1999). Therefore, the durability of *Hartford Accident*'s holding is doubtful.

However, legal commentators, such as Stephen S. Ashley, have taken the position that recognition of an independent duty between the primary and excess carrier is not only logical, but prudent. Stephen S. Ashley, *Bad Faith*

Actions: Liability and Damages § 6:12 (West 1997). They explain that the violation of good faith, non-contractual obligations between an insured and the primary insurer may be remedied in tort. When faced with a primary carrier's unreasonable settlement outside of primary policy limits, the excess insurer stands in the position of the insured. So, they ask, why shouldn't the excess carrier be able to sue the primary carrier for bad faith handling of the claim? Why should the excess insurer be penalized by the insured's conduct and not be able to recover the entire amount that will compensate it for all the detriment proximately caused by the primary insurer? *See* Cal. Civ. Code § 3300 (providing recoverable damages in a tort action). California courts have yet to face the issue.

VIII. CONCLUSION

After review of the above paragraphs, the answer to a primary insurer representative's question, "Why doesn't the excess carrier drop down?" is clear – isn't it? So much information and analysis is required to answer the question accurately that it is no wonder why excess carriers are often slow to respond to insured and primary carrier tenders.

Hopefully, however, review of these materials has assisted your understanding of the various elements involved in determining whether a given policy is "exhausted" or deciding whether an obligation to "drop down" exists. You have become familiar with the mathematics required to determine primary, additional insured, and excess carrier pro rata shares of losses. And you acknowledge the importance of timely and proper notice and know when to commence legal action, if necessary, to enforce the terms of the policy or apportion losses among insurers. If you represent an excess carrier, familiarity with the rules described above will assist you in making better business decisions for your company. If you represent a primary or additional insured carrier, understanding these concepts will help you to provide excess insurers with information crucial to their decisions, and hopefully, speed up their responses.

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Aetna Casualty & Surety Co. v. Certain Underwriters at Lloyds, 56 Cal. App. 3d 791, 804-05 (Cal. Ct. App. 2d 1976).... 5, 12
Aetna Casualty & Surety Co. v. Centennial Ins. Co., 838 F. 2d 346, 350-51 (9th Cir. 1988) 10
AIU Ins. Co. v. Sup. Ct., 51 Cal. 3d 807, 814-15 (Cal. 1990) 8
Allstate Ins. Co. v. RJT Enters., 692 So. 2d 142, 144 (Fla. 1997) 12
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Bohemia, Inc. v. Home Ins. Co., 725 F. 2d 506, 515 (9th Cir. 1984)....34
Campbell v. Allstate Ins. Co., 60 Cal. 2d 303, 305 (Cal. 1963)....30
Chubb / Pacific Indem. Group v. Ins. Co. of No. America, 188 Cal. App. 3d 691, 695-96 (Cal. Ct. App. 2d 1987) 8, 13, 16
Coca Cola Bottling Co. v. Columbia Casualty Ins. Co., 11 Cal. App. 4th 1176, 1183 (Cal. Ct. App. 4th 1992) 6, 19
Commerce & Industry Ins. Co. v. Chubb Custom Ins. Co., 75 Cal. App. 4th 739, 743-44 (Cal. Ct. App. 1st 1999) 28
Commercial Union Assurance Cos. v. Safeway Stores, Inc., 26 Cal. 3d 912, 921 (Cal. 1980)....35
Communale v. Traders & General Ins. Co., 50 Cal. 2d 654, 659 (Cal. 1958) 32
Community Redev. Agency v. Aetna Cas. & Sur. Co., 50 Cal. App. 4th 329, 339-40 (Cal. Ct. App. 2d 1996) 14
Continental Casualty Co. v. Royal Ins. Co., 219 Cal. App. 3d 111, 117-18 (Cal. Ct. App. 1st 1990).... 33, 34
Continental Ins. Co. v. Lexington Ins. Co., 55 Cal. App. 4th 637, 643 (Cal. Ct. App. 2d 1997) 10
Continental Marble & Granite Co. v. Canal Ins. Co., 785 F. 2d 1258, 1259 (5th Cir. 1986) 17, 18
Crisci v. Security Ins. Co., 66 Cal. 2d 425, 429 (Cal. 1967) 32
CSE Ins. Group v. Northbrook Property & Casualty Co., 23 Cal. App. 4th 1839, 1844 n.1 (Cal. Ct. App. 2d 1994)....10
Dart Industries, Inc. v. Commercial Union Ins. Co., 28 Cal. 4th 1059, 1080 (Cal. 2002) 28
Denny's, Inc. v. Chicago Ins. Co., 234 Cal. App. 3d 1786, 1794 (Cal. Ct. App. 2d 1991) 19
Donald B. MacNeal, Inc. v. Interstate Fire & Cas. Co., 477 N.E. 2d 1322, 1325 (Ill. Ct. App. 1st 1985)....19
Fireman's Fund Ins. Co. v. Maryland Cas. Co., 65 Cal. pp. 4th 1279, 1304 (Cal. Ct. App. 1st 1998)....5, 9

Fireman's Fund Ins. Co. v. Maryland Casualty Co., 65 Cal. App. 4th 1279, 1305 (Cal. Ct. App. 1st 1998) 9, 22, 26
FMC Corp. v. Plaisted & Cos., 61 Cal. App. 4th 1132, 1190 (Cal. Ct. App. 6th 1998) 11
Fortman v. Safeco Ins. Co., 221 Cal. App. 3d 1394, 1400-01 (Cal. Ct. App. 2d 1990) 34
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Hartford Acc. & Indem. Co. v. Continental Nat'l American Ins. Cos., 861 F. 2d 1184, 1186 (9th Cir. 1988) 11, 12
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Hartford Accident & Indemnity Co. v. Sequoia Ins. Co., 211 Cal. App. 3d 1285, 1295 (Cal. Ct. App. 5th 1989) 5, 8
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Hudson Ins. Co. v. Gelman Sciences, Inc., 706 F. Supp. 25, 28 (N.D. Ill. 1989) 18
Iolab Corp. v. Seaboard Sur. Co., 15 F. 3d 1500, 1505 (9th Cir. 1994) 14
Johnson v. Continental Ins. Cos., 202 Cal. App. 3d 477, 486 (Cal. Ct. App. 2d 1988) 12
Kelley v. British Commonwealth Ins. Co., 221 Cal. App. 2d 554, 562 (Cal. Ct. App. 1st 1963) 33
Liberty Mutual Ins. Co. v. Altfillisch Construction Co., 70 Cal. App. 3d 789, 797 (Cal. Ct. App. 4th 1977) 32
Lulich v. Sherwin-Williams Co., 799 F. Supp. 64, 69 (N.D. Ill. 1992) 27
Maine Bonding & Casualty Co. v. Centennial Ins. Co., 693 P. 2d 1296, 1297-1302 (Or. 1985) 6
Maricopa County v. Federal Ins. Co., 757 P. 2d 112, 114 (Ariz Ct. App. 2d 1988) 17
Montrose Chemical Corp. v. Admiral Ins. Co., 10 Cal. 4th 645, 687-88 (Cal. 1995) 15
National Union Fire Ins. Co. v. Travelers Ins. Co., 214 F. 3d 1269, 1273 (11th Cir. 2000) 12, 17
National American Ins. Co. v. Ins. Co. of North America, 74 Cal. App. 3d 565, 576 (Cal. Ct. App. 1st 1977) 21
North River Ins. Co. v. American Home Assurance Co., 210 Cal. App. 3d 108, 114 (Cal. Ct. App. 2d 1989) 10
Northwestern Mutual Ins. Co. v. Farmers Ins. Group, 76 Cal. App. 3d 1031, 1041 (Cal. Ct. App. 4th 1978) 33, 34
Northwestern Title Sec. Co. v. Flack, 6 Cal. App. 3d 134, 141 (Cal. Ct. App. 1st 1970) 30
Olympic Ins. Co. v. Employers Surplus Lines Ins., 126 Cal. App. 3d 593, 597-98 (Cal. Ct. App. 1st 1981) 5, 7, 8, 9, 13, 14

Pacific Employers Ins. Co. v. Domino's Pizza, Inc., 144 F. 3d 1270, 1276-77 (9th Cir. 1998) 11

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Phico Ins. Co., Inc. v. Aetna Cas. & Sur. Co. of America, 93 F. Supp. 2d 982 (S.D. Ind. 2000) 35

Phoenix Ins. Co. v. United States Fire Ins. Co., 189 Cal. App. 3d 1511, 1529-30 (Cal. Ct. App. 2d 1987) 13, 16, 21, 31

Presley Homes, Inc. v. American States Ins. Co., 90 Cal. App. 4th 571, 576 (Cal. Ct. App. 4th 2001) 21, 22

R.W. Beck & Assocs. v. City and Borough of Sitka, 27 F. 3d 1475, 1480-82 (9th Cir. 1994) 7

Rabouin v. Metropolitan Life Ins. Co., 182 Misc. 2d 632 (N.Y. Sup. Ct. 1999) .. 35

Radiator Specialty Co. v. First State Ins. Co., 651 F. Supp. 439, 441-42 (W.D. N.C. 1987) 19, 20

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Sequoia Ins. Co. v. Royal Ins. Co., 971 F. 2d 1385, 1393-94 (9th Cir. 1992) 29

Shell Oil Co. v. National Union Fire Ins. Co., 44 Cal. App. 4th 1633, 1642 (Cal. Ct. App. 2d 1996) 22

Shell Oil Co. v. Winterthur Swiss Ins. Co., 12 Cal. App. 4th 715, 761-63 (Cal. Ct. App. 1st 1993) 29

Signal Cos. V. Harbor Ins. Co., 27 Cal. 3d 359, 366 (Cal. 1980) 11, 12, 13, 33

Span, Inc. v. Associated Int'l Ins. Co., 227 Cal. App. 3d 463, 483 (Cal. Ct. App. 2d 1991) 16, 18

St. Paul Fire & Marine Ins. Co. v. Children's Hosp. Nat'l Med. Center, 670 F. Supp. 393, 402 (D.D.C. 1987) 31

St. Paul Fire and Marine Ins. Co. v. American Dynasty Surplus, 101 Cal. App. 4th 1038, 1056 (Cal. Ct. App. 2d 2002) 26

Ticor Title Ins. Co. v. Employer Ins. Of Wausau, 40 Cal. App. 4th 1699, 1708-09 (Cal. Ct. App. 1st 1995) 16

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Transit Cas. Co. v. Spink Corp., 94 Cal. App. 3d 124, 131 (Cal. Ct. App. 3d 1979) 32, 35

Travelers Casualty & Surety Co. v. American Equity Ins. Co., 93 Cal. App. 4th 1142 (Cal. Ct. App. 1st 2001) 9

Union Indemn. Ins. Co. v. Certain Underwriters at Lloyd's, 614 F. Supp. 1015, 1017 (S.D. Tex. 1985) 5
United States Fire Ins. Co. v. Coleman, 754 S.W. 2d 941, 944 (Mo. App. E.D. 1988) 18
Valentine v. AETNA Ins. Co., 564 F. 2d 292, 297 (9th Cir. 1977) 34
Vitton Const. Co. v. Pacific Ins. Co., 2 Cal. Rptr. 3d 1, 6 (Cal. Ct. App. 1st 2003) 26
Vons Cos., Inc. v. United States Fire Ins. Co., 78 Cal. App. 4th 52, 62 (Cal. Ct. App. 2d 2000) 11
Wells Fargo Bank v. California Ins. Guarantee Assn., 38 Cal. App. 4th 936, 940 n.2 (Cal. Ct. App. 1st 1995) 5, 19
Whitehead v. Fleet Towing Co., 110 Ill. App. 3d 759, 764 (Ill. App. Ct. 5th 1982) 5, 6
Whiting Corp. v. Home Ins. Co., 516 F. Supp. 643, 646 (S.D.N.Y. 1981) 31
Wiemann v. Industrial Underwriters Ins. Co., 177 Cal. App. 3d 38, 41 (Cal. Ct. App. 2d 1986) 5
Zurich Ins. Co. Heil Co., 815 F. 2d 1122, 1125 (7th Cir. 1987) 19, 20

Statutes

California Civil Code § 2782(a) 22

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Index

"Amount Recoverable" 19
"Bad Faith" Letter 33
"Completed Operations" Coverage 26
"Covered" 19
"Drop Down" 15
"Drop Down" Triggers 15
"Exhaustion of Underlying Insurance" 19
"Independent and Direct Duty" Theory 35
"Maintenance of Underlying Insurance" Clause 20
"Triangular Reciprocity" Theory 35

“Clear and Unambiguous” 18
“Liability Arising Out Of” 23
“Other Insurance” Clause 8

Additional Insured Endorsement 21
Advisability of Voluntarily "Dropping Down" 20
Aggregate Excess Policy 13
AI’s Sole Negligence 22
Apportionment 27

Broad as Primary Excess Policy 7
Broad As Primary Excess Trigger 7

Calculation of Pro Rata Share of Loss 28
Catastrophe Excess Policy 13
Claim Acknowledgement 30
Claim Settlement 32
Continuing Loss Exhaustion 13

Deductibles 11
Definition of "Exhaustion" 12
Duty of Good Faith and Fair Dealing 32
Duty to Defend 12
Duty to Indemnify 12
Duty to Inquire 16

Equitable Subrogation 34
Escape Clause 9
Excess "Other Insurance" 9
Excess Insurance 5

Excess Policy Features 8
Exhaustion 11
Expenses Paid by Excess Carrier 8
Express Indemnity Agreement 27
Extent of Duty to Defend 12

Failure to Procure AIE Per Contract 27
Following Form Excess Policy 6

Horizontal Exhaustion 14

Implied Excess Insurance 6
Insolvency As "Exhaustion" 14
Insured Notice of a Claim 29
ISO AIE Form Commonalities 22

Notice of Claims 29

Operation of Law 8

Primary Insurance 5
Primary Insurer Notice of a Claim 29
Pro rata 9
Proper Notice 29
Pure Excess 5

Refusal to Defend 16
Reservation of Rights 31
Response to Claim 30

Scope of AIE 22
Self-Insured Retentions 11
Sources of Payment for the Loss 28
Specific Excess Excess Trigger 7
Stand Alone Excess Policy 6
Straight Excess 5

Timeliness of Notice 29
Triggers of Excess Coverage 7
True Excess 5

Umbrella Policies 10

Vertical Exhaustion 13

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