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NEWSLETTER

Excess Policies Not Triggered Where Insured Settles with Primary Carrier for Less Than Full Limit

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The Washington Court of Appeals, applying Washington law, has held that two excess professional liability insurance policies requiring exhaustion of the full underlying limit by payment by the underlying carrier afford no coverage for costs incurred by the insured in defending against various client claims and governmental investigations arising from its sale of tax shelters where the insured settled its coverage dispute with the primary carrier for payment by the primary carrier of less than half its limit. *Quellos Group, LLC v. Federal Ins. Co.*, No. 68478-7-I (Wash. Ct. App. Nov. 12, 2013). The court affirmed the trial court's entry of summary judgment in the insurers' favor, concluding that the excess policies' exhaustion language "reflects the distinguishing characteristic and function" of the excess policies rather than constituting a condition to coverage. Wiley Rein represented the first-layer excess insurer.

The insured investment advisor developed a proprietary tax shelter, which it sold to several clients from 2000 to 2001. U.S. Internal Revenue Service (IRS) audits of the clients' tax returns led to an IRS investigation of the advisor, as well as a federal criminal probe. Several of the clients also asserted claims, which the insured settled, and a U.S. Senate subcommittee also launched an investigation. The federal criminal investigation resulted in the indictment of the advisor's CEO and tax planning principal, who eventually pleaded guilty to conspiracy to defraud the IRS and counseling false tax returns. The advisor sought coverage for the costs incurred in settling the client claims and responding to the various investigations under a program of investment management insurance. Prior to the criminal convictions, the primary carrier paid less than half of its $10 million primary limit and declined to make any further payments after entry of the guilty pleas. The first- and second-level excess carriers also declined to advance any sums on the basis of various policy exclusions and the primary carrier's failure to exhaust.

Coverage litigation ensued, and the advisor settled with the primary carrier with respect to several policy years concerning different tax strategies. The settlement did not allocate any further payment by the primary carrier under the relevant policy period. The excess insurers moved for summary judgment on the basis of both application of various conduct-related exclusions and the advisor's failure to exhaust the primary coverage. The excess insurers' policies provided that they attached "only after the insurers of the Underlying Insurance shall have paid in legal currency the full limit of the Underlying Limit for such Policy Period" and

"only after all of the Underlying Insurance has been exhausted by the actual payment of loss by the applicable insurers thereunder," respectively. The trial court granted the insurers' motion on exhaustion grounds, and the advisor appealed.

The appellate court affirmed, holding that "the plain and unambiguous language compels the conclusion that excess coverage was not triggered by the agreement of the [advisor] to pay the policy limit of approximately $5 million that [the primary carrier] refused to pay." Rejecting the advisor's contention that the exhaustion requirements contained in the excess policies were mere conditions, the court opined that "[t]he language 'only after' reflects the distinguishing characteristic and function of an excess insurance policy." As such, the court "reject[ed] the argument that the exhaustion requirement should be treated in the same manner as a cooperation or notice requirement."

The appellate court further declined to find that the excess policy terms contained "standardized language" that had to be construed against the insurers. The court pointed to the availability of endorsements and other excess policy forms that would have permitted the insured to pay the difference between a carrier's payment and the full underlying limit in order to trigger excess coverage. The court distinguished *Zeig v. Massachusetts Bonding & Insurance Co.*, 23 F.2d 665 (2d Cir. 1928), and its progeny, observing that "[h]ere, unlike in *Zeig*, the plain and unambiguous language of the excess insurance policies unambiguously states how the underlying insurance is exhausted. The policies require the underlying insurer to pay the full amount of its limits of liability before excess coverage is triggered."