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Excess vs. Primary: Untold Stories and Lessons Learned

I. The Primary & Excess Relationship

The relationship between primary and excess insurance carriers can be amicable or combative. A clear understanding of the difference between the two types of policies – both in name and in function – is key to understanding their relationships and the potential pitfalls in claims that trigger these policies.

Primary Insurance is written to insure against specific risks, such as property damage, premises liability, or motor vehicle liability. The policy is specifically tailored and premiums priced to cover explicit risks.

When an insured is engaged in activity that creates a risk for judgment above its primary policy limits, the insured can either pay out of pocket for any amount of a claim exceeding their primary coverage; or obtain an excess policy.

An excess policy covers only the risks that the primary policy covers. It is important insureds understand excess insurance does not expand the scope of the primary policy's coverage, but simply raises the policy limits.

a. Review of Standards and Case Law

The long-standing rule dictating the general nature of primary and excess insurance coverage is denoted in *Transit Casualty Co. v. Spink Corp*. (1979) 94 Cal.App.3d 124:

> "The policyholder pays for two kinds of liability coverage, each at a different rate. The premium charged by the primary insurer supports more localized claims adjustment facilities than those of the excess carrier. It takes into account costs of defense, including legal fees, which the primary insurer normally provides. The excess carrier is less frequently confronted with loss possibilities and, when it is, may employ local adjusters. The primary insurer is assisted, not impeded, by the active participation of another carrier with a stake in the negotiations. Self-interest will impel the primary

> carrier to take the lead when settlement value is well within its policy limits, the excess carrier when the claim invades its own policy exposure. When settlement value hovers over the fringes of both policies, both carriers may collaborate." (*Transit Casualty Co. v. Spink Corp. (1979)* 94 Cal.App.3d 124, 135.)

In the event a coverage dispute arises between the primary and excess carrier, the excess carrier forfeits the right to dispute the settlement terms negotiated by the primary carrier.

> “when an excess insurer denies excess coverage for a third party claim, it waives the right to challenge the reasonableness of the primary insurer’s settlement of the claim” (*United Services Automobile Assn. v. Alaska Ins. Co.* (2001) 94 Cal.App.4th 638, 644.)

II. Scenario 1 - High Exposure CD

At issue is a mixed used property in a new trendy area of West Hollywood. The first floor is retail with 19 stories of high end condominiums above it. The building owners and HOA sue the builder for alleged defects associated with the exterior cladding. It is alleged a combination of poor workmanship and an incompatible sealant have led to window and podium deck leaks. To date there have been less than 10 leaks reported, although several of these occurred at the penthouse. The initial thoughts of the builder's representatives are that these window leaks are site specific problems that can be address with in place repairs. The HOA and homeowners are convinced the exterior cladding will never perform as intended and must therefore be replaced in its entirety. The lawsuit has just been filed. The plaintiffs' initial cost of repair is $20 million.

The builder is insured under a primary wrap policy with $2 million in per occurrence limits. All implicated trades are enrolled in the wrap. The policy has a $100,000 self-insured retention, and defense costs erode the policy limits. The policy affords coverage for "property damage." It also contains the typical business risk exclusions. In addition, the builder has a "following form" excess policy of $15 million. The excess policy contains language granting the excess carrier the right, but not the obligation, to associate in the insured's defense as it deems necessary to protect its interests. The builder's personal counsel has tendered to the primary and excess carriers and commenced its initial investigation.

III. Scenario 2 – Construction Site Injury

A national retailer hires a general contractor to construct a new “superstore.” The project initially requires the general contractor to perform demolition work to prepare the site for construction. The general contractor hires a demolition subcontractor, who in turn hires its own subcontractor to perform some fairly extensive concrete cutting. The general contractor also engages an electrical contractor to provide temporary construction lighting. During the course of the project Plaintiff, a 27 year old employee of the demolition sub, is seriously injured when a concrete walkway collapses beneath him. Plaintiff fell 15 feet, landing first on his shoulder and then hitting his head. There are conflicting reports as to whether he lost consciousness.

Plaintiff sues the owner/retailer, the general contractor, the concrete cutter and the electrical sub. Plaintiff's employer is immune based on workers comp exclusivity. Plaintiff alleges TBI, PTSD and seeks recovery for past and future shoulder surgeries. Total past medical expenses are $75,000. Plaintiff recently associated in a well-known TBI attorney who presented a $40 million life care plan.

The electrical contractor has a $1 million primary policy with $5 million in excess coverage. The primary carrier for the electrical sub has retained panel counsel who is defending the matter. The owner/retailer recently filed a successful summary judgment motion. The other two defendants have a total of $15 million (GC $10 million; Concrete Cutter $5 million) in available coverage. According to the experts, the concrete cutter undermined the integrity of the walkway and is the "target defendant." According to the mediator, there is a "chance" the matter can resolve for $21 million.

IV. The Current Primary/Excess Environment

***Ace American Ins. Co. v. Fireman's Fund Ins. Co*., 2 Cal. App. 5th 159**

Summary: Excess Insurer, Ace American, believed the primary insurer, Fireman's Fund, unreasonably rejected settlement offers within the Fireman's Fund's policy limits, resulting in Ace American contributing to the eventual settlement and Ace American filing an action for equitable subrogation. Fireman's Fund argued equitable subrogation did not apply because the lawsuit had settled and there was no judgment against the insured.

The court decided to follow *Fortman* rather than *RLI*. The court rejected the *RLI* court's conclusion that *Fortman* conflicted with *Hamilton* (*Ibid* at 170-71.) believing the focus of *Hamilton* "was whether there was sufficient evidence that the insured had suffered actual damages—not whether damages came in the form of an excess judgment versus an excess settlement." (*Ibid*. 172)

Further, the court found the fact that the *Hamilton* court distinguished its decision in *Isaacson v. California Ins. Guarantee Assn.* (1988) 44 Cal.3d 775 from the decision reached in *Hamilton* to be instructive. In *Isaacson*, the court held the insured may recover the amount of their payment from the insurer in an action for bad faith failure to settle when the insurer's unreasonable refusal to pay a settlement demand within policy limits. (*Hamilton v. Maryland Casualty Co.* (2002) 27 Cal.4th 718, 731.) Whereas in *Hamilton* the insurer did not agree to the settlement, and there was an agreement not to execute the settlement against the insured, and therefore no real damages to the insured.

Therefore, the court held *Hamilton* could not meant to read that the only way to prove damages from an unreasonable failure to settle within policy limits was through a judgment in excess of policy limits. As a result, Ace American could proceed with an action against Fireman's Fund for equitable subrogation.

Takeaway: A primary insurer can be sued for equitable subrogation by the excess insurer, even without an excess judgment, so long as the excess insurer contributed to an excess settlement.

***RLI Ins. Co. v. CNA Casualty of California*, 141 Cal. App. 4th 75**

Summary: A driver was involved in a traffic accident that caused a victim's death. (*RLI Ins. Co. v. CNA Casualty of California*, 141 Cal. App. 4th 75, 79.) The driver had a primary insurance policy and an excess insurance policy, both with a limit of $1 million. (*Ibid.*) The primary insurer rejected the offer from the victim’s family for the policy limit of $1 million. A year later, the case settled for $2 million, with each insurer paying $1 million. (*Ibid.*) The excess insurer brought an equitable subrogation action alleging the primary insurer unreasonably refused the initial offer to settle within the policy limit.

The court held that, following *Hamilton*, the right to recover from a primary insurer “hinges upon ‘a judgment in excess of policy limits.’” (Ibid at 82.) Therefore, without an excess judgment the primary insurer's refusal to settle is not actionable because without an excess judgment, the driver suffered no harm, and therefore has no claim to assert against the primary insurer. Because “the subrogation rights of the excess insurer are coequal to and derivative of the rights of the insured” the excess insurer has no claim to assert against the primary insurer. (*Ibid.*) Additionally, the court refused to follow *Fortman v. Safeco Ins. Co*., 221 Cal. App. 3d 1394 for three reasons: (1) *Fortman* conflicts with Hamilton; (2) *Fortman* followed a rule relevant to equitable contribution rather than equitable subrogation; and (3) *Fortman* improperly relied on *Continental Casualty Co. v. Royal Ins. Co.* (1990) 219 Cal.App.3d 111, in which the primary insurer abandoned its defense of the insured.

Takeaway: Without an excess judgment, the insured has suffered no harm, and therefore the excess insurer cannot bring an action for equitable subrogation.

***Fortman v. Safeco Ins. Co*., 221 Cal. App. 3d 1394**

Summary: A child was injured when she fell from a moving car, resulting in a personal injury lawsuit against Austin hardware and Supply, Inc., the component part manufacturer of the door handle and lock, among others. (*Fortman v. Safeco Ins. Co*., 221 Cal. App. 3d 1394, 1397.) Before trial the primary insurance refused to settle for $125,000. (*Ibid.*) During trial the primary insurer settles for the full amount of the policy, plus $1,125,000 from the excess insurer and assigning to the plaintiff its equitable subrogation claim against the insurer. (*Ibid.*) The trial continued against the other defendants, and the plaintiff was awarded $24 million, however the jury awarded 0 percent fault to Austin. (Id at 1398.)

The plaintiff brought an equitable subrogation claim against the primary insurer, Safeco. Safeco argued that equitable subrogation was not available because the jury had assigned no fault to Austin, and therefore there was no judgment against the insured in excess of the policy limits. (*Ibid.*)

The court held that because the excess insurer actually paid a portion of its excess coverage as a part of the settlement, as a direct result of Austin's unreasonable refusal of offers to settle the case within its policy limits, an action for equitable subrogation was not barred by the absence of an excess judgment. The court specifically noted that the primary insurer repeatedly, and allegedly in bad faith, refused settlement offers below its policy limits, and action between liability insurers are based on "'equitable principles designed to accomplish ultimate justice in the bearing of a specific burden'" as opposed to contract (*Id.* at p. 1399, quoting *American Auto. Ins. Co. v. Seaboard Sur. Co.* (1957) 155 Cal.App.2d 192, 196 [318 P.2d 84].)

<u>Takeaway:</u> When the primary insurer acts in bad faith and it results in actual payment by the excess insurer there will likely be a cause of action for equitable subrogation.

Hamilton v. Maryland Casualty Co. (2002) 27 Cal.4th 718

<u>Summary</u>: The insurer refused to settle under the policy limits, and as a result the claimant and insured, without the insurer's participation, entered into a stipulate judgment in excess of the policy limits in which the claimant agrees not to execute against the insured. (*Hamilton v. Maryland Casualty Co*. (2002) 27 Cal.4th 718, 721-22.) Additionally, the insured assigns the claimant the insured's cause of action for breach of the insurer's duty to accept a reasonable settlement demand. (*Ibid.*)

The Court noted the rule in California that "an implied duty on the part of the insurer to accept reasonable settlement demands on [covered] claims within the policy limits," (*Id.* at 724.) and that an insured can protect themselves against excess judgment by assigning their cause of action for bad faith against the insured in return for a covenant not to enforce the judgment against the insured. (*Id.*at 725). However, the Court also recognized that this assignment is not operative a judgment in excess of the policy limits has been entered against the insured. (*Ibid.*) The Court followed a line of cases that found settlements reached without the consent or participation of the defending insurer, and including a covenant not to execute or another similar device, bear no weight in an action against the insurer for failure to settle. (*Id.* at 726.) The Court did not find the fact that the settlement here was approved under Code of Civil Procedure section 877.6 to be a distinguishing factor because the insurer had not refused the insured a defense. (*Id.* at 728.)

Additionally the Court distinguished the case from *Isaacson* (where an insured who contributes payment to conclude a settlement because of an insurer's unreasonable refusal to pay a settlement demand can bring an action for bad faith despite the absence of a litigated excess judgment) because the insurer did not participate or agree to a stipulate judgment, the agreed judgment cannot be fairly attributed to the insurer's conduct. (*Id.* at 731.)

Therefore, the Court held that when a settlement is reached in which an insurer has not participated and does not agree the insurer cannot fairly be bound to it. Further, there is no presumption of damages for a stipulated judgment in excess of policy limits when the insured is relieved from personal liability when there is a covenant not to execute.

<u>Takeaway</u>: The insurer's lack of participation in a settlement bears great weight on establishing whether an action for bad faith to settle can be brought. Additionally, there is no presumption of damages for a stipulated judgment when the insured is relieved from personal liability.

Diamond Heights Homeowners Assn. v. National American Ins. Co., 227 Cal. App. 3d 563

<u>Summary</u>: A developer and a general contractor entered a settlement with a homeowners association resulting in a stipulated judgement, cash up to the amount left in the insurance policy, and an assignment to the homeowners association of the rights of the developer and general contractor against the noncontributing insurance carriers: American, National, and Central. (Diamond Heights Homeowners Assn. v. National American Ins. Co. (1991) 227 Cal. App. 3d 563, 570.) The settlement was confirmed as being in good faith under California Code of Civil Procedure section 877.6. (*Ibid.*)

The homeowners association then moved to satisfy the balance of the judgment. National, the primary insurer, and American, who issued an umbrella policy were properly granted summary judgment as a result of exclusionary provisions in their contracts. (*Id.* at 571.) Central, who provided an umbrella policy with excess coverage, was not granted summary judgment, regardless of a "no action" clause, "providing that the insured could make a claim of loss 'after the Insured's liability shall have been fixed and rendered certain either by final judgment against the Insured after actual trial or by written agreement of the Insured, the claimant, *and the Company* [*Central*].' (Italics added.)" (*Id.* at 575.) Central had been notified the primary insurer was providing a defense and that settlement demands exceeded primary coverage and that it was likely primary policy limits would be exhausted. (*Ibid.*) The matter settled on the first day of trial, without Central's contribution and with its objection to the settlement on the record. (*Ibid.*) Central argued that their lack of consent to the settlement should have barred the homeowner's associations claim of loss. (*Id.* at 576.)

The court disagreed, explaining that the primary insurer has a duty to defend which grants them control over all aspects of the defense, including the negotiation of any settlement prior to trial. (*Id.* at 578.) However, in conducting settlement negotiations both the primary and excess insurer are subject to, "an implied duty of good faith and fair dealing which requires it to consider the interests of the insured equally with its own and evaluate settlement proposals as though it alone carried the entire risk of loss. [Citation.]" (*Ibid.*) Further, the primary insurer owes a duty of good faith to the excess carrier which is identical to that owed to its insured. (*Ibid.*)

Therefore, in determining the reasonableness of a settlement, the excess insurer must consider whether "the settlement bears a reasonable relation to the potential for liability and maximum likely recovery if the case proceeds to trial, and, in addition, the costs of defense and burdens imposed upon all parties if the litigation continues." (*Id.* at 580.) The excess insurer does not have the absolute right to veto a reasonable settlement and, as a result, force the primary insurer to proceed to trial and bear the full costs of defense. (*Ibid.*) This is consistent with the good faith duty. (*Ibid.*)

Takeaway: Consistent with the duty of good faith, an excess insurer does not have an absolute right to veto a reasonable settlement and force the primary insurer to bear the burden of full cost of defense for trial.

Commercial Union Assurance Cos. v. Safeway Stores, 26 Cal. 3d 912

Summary: An excess liability insurer brought an action against the primary insurer, alleging they had an opportunity to settle the case within the limits of the primary insurance and there was a possible and probable liability above the primary insurance limits. (*Commercial Union Assurance Cos. v. Safeway Stores* (1980) 26 Cal. 3d 912, 916.)

However, the court explained that, "[t]he insured owes no duty to defend or indemnify the excess carrier; hence, the carrier can possess no reasonable expectation that the insured will accept a settlement offer as a means of "protecting" the carrier from exposure. The protection of the insurer's pecuniary interests is simply not the object of the bargain." (*Id.* at 919.) This is because, while the primary insurer provides defense to the insured to protect them from liability and as a result there is an expectation of a settlement within the policy limits, these expectations do not flow from the insured to the excess insurer in the same way. (*Ibid.*)

The court further distinguished away from cases where the duty of good faith between the primary and excess insurer was violated because there was no aggravated conduct on the part of the primary insurer or insured to take advantage of the excess carrier.

The court ultimately held that, "a policy providing for excess insurance coverage imposes no implied duty upon the insured to accept a settlement offer which would avoid exposing the insurer to liability. Moreover such a duty cannot be predicated upon an insured's implied covenant of good faith and fair dealing. If an excess carrier wishes to insulate itself from liability for an insured's failure to accept what it deems to be a reasonable settlement offer, it may do so by appropriate language in the policy. We hesitate, however, to read into the policy obligations which are neither sought after nor contemplated by the parties." (*Id.* at 921.)

Takeaway: The duty of good faith does not require the primary insurer to settle a case within the policy limits in order to protect the excess carrier. If the excess insurer wants more protection in these situations they should write them into the policy.