

Not All Policies Are Created Equal: Evergreen State Appeals Court Blocks Policyholder Reach to Excess Insurance After Settlement With Primary Insurer

Insurance Recovery Litigation & Counseling Alert

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The decision in *Quellos Group LLC v. Federal Insurance Co.*, No. 68478-7-1 (Wash. Ct. App. Nov. 12, 2013) is a reminder that vague policy language can be costly. You may not have access to your excess insurance funds. The Court of Appeals of Washington strictly construed language in two excess policies, finding that the policyholder could not recover loss in excess of its primary policy from its excess insurers after *Quellos* settled with its primary insurer for less than the primary policy's limits, even after the policyholder agreed to pay the difference between the settlement amount and the full limit of the underlying insurance.

Quellos, an investment management company, faced threats of litigation from its clients and federal government investigations concerning an allegedly fraudulent tax shelter it developed. In 2006 and 2007, *Quellos* settled with clients for approximately \$35 million. *Quellos* also incurred approximately \$45 million in defense fees and other costs in connection with investigations and audits by the IRS, a U.S. Senate subcommittee and the U.S. Attorney's Office concerning the tax shelter. It sought reimbursement of these amounts from its insurers.

Quellos had primary coverage under American International Specialty Lines Insurance Company (AISLIC) claims-made Investment Management Insurance policies covering policy periods between 2000 and 2006. Excess coverage was issued by Federal Insurance Company (first-layer) and Indian Harbor Insurance Company (second-layer). The Federal excess policy provided that coverage "shall attach only after the insurers of the Underlying Insurance shall have paid in legal currency the full amount of the Underlying Limit." *Quellos Group*, No. 68478-7-1, *13. The Indian Harbor excess policy similarly provided that coverage "will attach only after all of the Underlying Insurance has been exhausted by the actual payment of loss by the applicable insurers thereunder." *Id.* at *15.

Following a coverage dispute between *Quellos* and primary insurer AISLIC, they reached settlement whereby AISLIC agreed

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to pay half (\$5 million) of its \$10 million primary coverage limits. Quellos then sought the balance of its losses from Federal and Indian Harbor; they denied coverage on the ground that although the otherwise covered loss exceeded the AISLIC primary policy's limits, the underlying primary insurance had not been exhausted by payment of loss. The insurers argued that they, therefore, had no obligation to pay any portion of the underlying loss incurred by Quellos.

Summary judgment motions were filed on whether the failure to exhaust primary coverage through actual payment by the primary insurer barred coverage under the excess policies. Quellos argued that: (1) "a literal interpretation of the exhaustion requirement [in the excess policies] violated the [public] policy of promoting settlements;" and (2) "the exhaustion requirements function[ed] as 'a condition to coverage,' [meaning that] the excess carriers waived the right to invoke the condition and could not establish breach of the exhaustion requirement was either material or prejudicial." *Id.* at *10, 17.

The trial court dismissed Quellos's claims against Federal and Indian Harbor, ruling that under the plain and unambiguous language of the excess policies, the limits of the policies underlying the Federal and Indian Harbor excess policies were not exhausted. The trial court also rejected Quellos's argument that the excess policies' exhaustion language was a condition precedent to coverage, holding, instead, that the exhaustion requirement was "the defining characteristic of an excess insurance policy." *Id.* at *10-11.

The Washington Court of Appeals agreed. Applying Washington law, but also examining decisions in other jurisdictions, the court found that the Federal and Indian Harbor excess policies clearly and unambiguously were triggered only when the underlying insurance policy was exhausted by the underlying insurer's payment "in legal currency" or by the underlying insurer's "actual payment" of a claim, respectively. *Id.* at *16-17. The court also found that the phrase "only after" in the excess policies' insuring clauses did not transform the exhaustion requirement into a condition precedent to coverage; rather, that language merely reflected the "distinguishing characteristic and function of an excess policy." *Quellos Group, No. 68478-7-1*, *16-17. The court further rejected Quellos's policy argument, finding that public policy should not "override the unambiguous exhaustion language" in the excess policies. Noting the availability in the insurance market for alternative policy language allowing a policyholder to pay the full amount of underlying policy limits to trigger excess coverage, the court held that when faced with excess policies unambiguously dictating how the underlying insurance must be exhausted, such provisions are enforceable as written. *Id.* at *20.

Washington's Quellos court joins those that have strictly applied the "actual payment" exhaustion language in excess liability policies. Policyholders should evaluate the scope of coverage and explore, for example, obtaining alternative language that does not require an underlying insurer to actually pay its full limits in order to trigger the excess coverage. McCarter & English's insurance coverage group helps policyholders review existing insurance policies or new insurance placements, and helps them understand the insurance jargon in their policies before they sustain a loss and need coverage.