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THE "CARE AND FEEDING" OF EXCESS AND REINSURANCE CARRIERS: COMMUNICATION AND LITIGATION

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I. OVERVIEW:

This session will address current and emerging issues facing public entities and joint powers authorities in relation to claims and litigation implicating both multiple levels of insurance coverage and also reinsurance coverage, including issues of notice as well as defense and settlement issues. In addition to discussion of the pertinent issues, the panel will discuss real world examples of options in such situations.

The goal of the session is to help participants better evaluate and implement strategies for notification and coordination with excess and reinsurance carriers with respect to claims and resolutions thereof.

II. BRIEF OVERVIEW OF CALIFORNIA LAW REGARDING PRIORITY OF COVERAGE BETWEEN MULTIPLE INSURANCE CARRIERS

A. Distinctions Between Levels Of Coverage

1. Primary Coverage

- "Primary insurance" or "primary coverage" applies immediately upon the happening of an event potentially falling within the scope of a liability policy's insuring provision. (*See Montrose Chem. Corp. of California v. Superior Court* (2017) 14 Cal.App.5th 1306, 1322 ["Primary 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."]; *Cmty. Redevelopment Agency v. Aetna Cas. & Sur. Co*. (1996) 50 Cal.App.4th 329, 337 [same].)

2. Excess Coverage

- "Excess insurance" or "excess coverage" "begins only after a predetermined amount of underlying coverage is exhausted and that does not broaden the

underlying coverage." (*Wells Fargo Bank v. California Ins. Guarantee Assn*. (1995) 38 Cal.App.4th 936, 940.) As a result, it "provides coverage after other identified insurance is no longer on the risk." (*N. Am. Capacity Ins. Co. v. Claremont Liab. Ins. Co*. (2009) 177 Cal.App.4th 272, 291.)

- An excess liability policy can provide "specific excess" or "general excess" coverage.
    - If the excess policy's coverage is triggered after a specific policy or group of policies have been exhausted, it provides "specific excess" coverage. (*See Olympic Ins. Co. v. Employers Surplus Lines Ins. Co.* (1981) 126 Cal.App.3d 593, 598 ["When secondary insurance is written to be excess to identified policies, it is said to be 'specific excess.'"].)
    - Conversely, an excess policy can be described as a "general excess" policy if excess coverage is triggered after exhaustion of *both* scheduled, underlying insurance *and* "any other insurance providing coverage to the insured" for the same risk during the same policy period. (*See JPI Westcoast Const., L.P. v. RJS & Assocs., Inc*. (2007) 156 Cal. App. 4th 1448, 1463.)

3. Umbrella Coverage

- "Umbrella insurance" or "umbrella policies" are hybrid coverages which provide excess coverage and also primary coverage where other primary coverage is, for some reason, inapplicable.

- ◦ If underlying insurance provides liability coverage for the risk, the "umbrella" policy provides excess coverage. (*See CSE Ins. Grp. v. Northbrook Prop. & Cas. Co*. (1994) 23 Cal.App.4th 1839, 1844, n.1 ["All umbrella policies are excess policies in the sense they afford coverage that is excess over underlying insurance."].)
- ◦ However, if the insured's underlying policies do not provide liability coverage for the risk, an "umbrella" policy which does provide such coverage can "drop down" to provide primary coverage and act as a "gap filler". (*Reserve Ins. Co. v. Pisciotta* (1982) 30 Cal.3d 800, 812 ["The two coverage provisions, when read together, make the [umbrella] policy applicable either as excess insurance over any 'amounts recoverable' under the primary policy or as alternative primary coverage as to losses 'not covered by' the primary policy."]; *Energy Ins. Mut. Ltd. v. Ace Am. Ins. Co*. (2017) 14 Cal.App.5th 281, 287 n.1 ["Although similar, [excess and umbrella] policies differ in a critical aspect—an umbrella policy expands coverage and acts as 'gap filler,' providing first dollar coverage for certain risks that are not covered by a primary or excess policy."].)

4. Reinsurance

- A "reinsurance" policy is a "contract ... by which an insurer procures a third person to insure him against loss or liability by reason of such original insurance." (*Ascherman v. Gen. Reinsurance Corp.* (1986) 183 Cal.App.3d 307, 311 [citing Cal. Ins. Code §620].)
  - ◦ A reinsurance contract does not alter any of the terms, conditions, provisions or indemnity limits of the original insurance contract. (*Catholic*

Mut. Relief Soc. v. Superior Court (2007) 42 Cal.4th 358, 369; *Lipton v. Superior Court* (1996) 48 Cal.App.4th 1599, 1617.)

- "Typically, under a reinsurance contract, the primary insurer 'cedes' a portion of the premiums for its policies, and the losses on those policies, to the reinsurer. … The advantage of reinsurance is to secure to the original insurer adequate risk distribution by transferring a portion of the risk assumed to another insurer." (*Prudential Reinsurance Co. v. Superior Court* (1992) 3 Cal.4th 1118, 1123.)
  - Note: Technically, reinsurance is not limited to "one company reinsuring the rights of another company, the latter company still remaining liable on the original risk." (*Carpenter v. Pac. Mut. Life Ins. Co. of Cal*. (1937) 10 Cal.2d 307, 334.) It also includes "a contract by which one company (the new company here) takes over the insurance risks of another company (the old company here) and becomes substituted as insurer in the place and stead of the original insurer." (*Id.*)
- Because a reinsurance contract is designed so that an insurer can share the benefit and burden of providing liability coverage with another insurer, reinsurance contracts are "presumed to be a contract of indemnity for the benefit of the insurance company; the original insured has no interest in it." (*Ascherman, supra,* 183 Cal.App.3d 307, 311; *see also* Ins. Code §623 ["The original insured has no interest in a contract of reinsurance."].)
  - Because the insurer and not the insured has an interest in the reinsurance contract, reinsurance issues are generally immaterial to an underlying tort action brought against the insured. (*See Catholic Mut. Relief Soc. v. Superior Court* (2007) 42 Cal.4th 358, 368 [holding statute authorizing

limited discovery of a defendant's insurance coverage information did not authorize pretrial discovery of nonparty liability insurer's reinsurance agreements for purposes of facilitating pretrial settlement of underlying tort claims].)

  - However, in a bad faith action against a liability insurer, "correspondence between the insurer and re-insurer, not otherwise privileged, which discusses liability, exposure, the likelihood of a verdict in excess of policy limits or coverage issues may well be relevant in discovery for the same reasons reserve information may be discoverable." (*Lipton v. Superior Court* (1996) 48 Cal.App.4th 1599, 1617-1618.) At the same time, "where reinsurance documents include attorney-client or protected work product communications they would be entitled to the same privilege protection as would similar communications between the ceding insurer and its attorneys handling the insured's claim." (*Id.*)

- With respect to the relationship between the insured, the insurer and the reinsurer: (1) the insurer retains full responsibility for discharging *all* contractual obligations towards the insured (i.e. defense, settlement, etc.); and (2) the reinsurer is obligated only to reimburse the insurer unless the reinsurance contract gives it additional rights (i.e. to participate in settlement). (*Zenith Ins. Co. v. Cozen O'Connor* (2007) 148 Cal.App.4th 998, 1007.)

  - As a result, "if the ceding insurer decides to settle and pay a claim, the reinsurer cannot raise coverage defenses to avoid paying its share of the loss. Absent fraud or collusion with the insured, the reinsurer must 'follow the fortunes' of the ceding insurer on any claims under the policy…."

(*Zenith Ins. Co., supra*, 148 Cal.App.4th 998, 1007; *see also Sawyer v. Sunset Mutual Life Ins. Co*. (1937) 8 Cal.2d 492, 501 ["It is not necessary for a reinsurer to actively participate in the defense of the action, provided it is proved that the reinsurer has notice of the pendency of the action and is afforded an opportunity to defend, and the defense is carried on without fraud or collusion by the original insurer."].)

  - The reinsurer must "follow the fortunes" of the ceding insurer unless the language of the reinsurance contract expressly states otherwise or the reinsurer proves that there was a contrary, contractual intent. (*Id.*; *see also Nat'l Am. Ins. Co. of California v. Certain Underwriters at Lloyd's London* (9th Cir. 1996) 93 F.3d 529, 535 ["follow the fortunes" doctrine applied to reinsurance contract without "follow the fortunes" language by operation of common law unless reinsurer proves contractual intent was that reinsurance policy would not "follow the fortunes"].)

- **<u>Note Re: Reinsurance Of Coverage Under A Memorandum Of Coverage</u>**
  - Reinsurance contracts are not limited to contracts reinsuring commercial liability policies. (*See Carpenter, supra,* 10 Cal.2d 307, 334.) As such, they are commonly used by Joint Powers Authorities providing coverage under Memorandums of Coverage to spread the risk of loss.
  - Notwithstanding general California law requiring a reinsurer to "follow the fortunes" of the reinsured, the actual scope of coverage provided by the resinsurance contract is governed by the terms of reinsurance contract itself. As a result, a JPA should carefully scrutinize the resinsurance contract to make certain that all of the exclusions in the resinsurance

contract are incorporated into the Memorandum of Coverage, unless there are specific risks the JPA wishes to cover notwithstanding the lack of reinsurance for those risks.

- **<u>Issues Re: Notice To A Reinsurer</u>**
- Due to the insurer's ability to affect the obligations of a reinsurer, the insurer normally "must communicate all the representations of the original insured, and also all the knowledge and information he possesses, whether previously or subsequently acquired, which are material to the risk." (Cal. Ins. Code §622.)
- If a primary insurer breaches its notification duties and thereby causes substantial prejudice to the reinsurer (i.e. causes the reinsurer to pay more than it would have otherwise), under California law the reinsurer can avoid its payment obligations. (*See Ins. Co. of State of Pennsylvania v. Associated Int'l Ins. Co*. (9th Cir. 1990) 922 F.2d 516, 525.)
  - <u>Note</u>: However, breach of the insurer's notice obligations to the reinsurer without any resulting prejudice, standing alone, may be sufficient for a reinsurer to deny coverage if the reinsurance contract contains a choice of law provision applying another state's law (e.g. Alabama, Florida, etc.). (*See Pitzer Coll. v. Indian Harbor Ins. Co*. (C.D.Cal. 2014) 2014 WL 12558276, at *7 [choice of law provision in reinsurance policy required that New York law as opposed to California law governed late notice issues].)
  - Also, there is an issue whether the "notice-prejudice" rule would apply to a loss in California when the reinsurance contract was issued in a strict

notice jurisdiction (e.g. Alabama, Florida, etc.) under standard choice of law principles.

- ° Note: The Ninth Circuit has certified to the California Supreme Court the issue of whether the "notice prejudice" rule is a matter of California public policy for choice of law purposes. (*See Pitzer Coll. v. Indian Harbor Ins. Co*. (9th Cir. 2017) 845 F.3d 993.)

B. Legal Standards To Determine Priority Of Coverage Of Insurance Policies

a. "Battle Of The Forms" – The "Other Insurance" Clause

- An insured has "duplicate" or "double" insurance "where the same person is insured by several insurers separately in respect to the same subject and interest." (Cal. Ins. Code §590.) "It is certainly possible for an insured to have duplicative coverage, or arguably duplicative coverage, either deliberately or inadvertently." (*Martin Marietta Corp. v. Ins. Co. of N. Am*. (1995) 40 Cal.App.4th 1113, 1135.)

- To deal with duplicate liability coverage situations, virtually all liability policies contain "other insurance" clauses which "attempt to limit the insurer's liability where other insurance covers the same risk" and thereby "control the manner in which each insurer contributes to or shares a covered loss." (*Fire Ins. Exch. v. Am. States Ins. Co*. (1995) 39 Cal.App.4th 653, 660.)

- The effect of "Other Insurance" clauses are subject to three, competing legal rules:

- Priority of coverage "is generally determined by the explicit provisions of the respective 'other insurance' clauses." (*Burns v. California Fair Plan* (2007) 152 Cal.App.4th 646, 657.)
- At the same time, "other insurance" clauses are the subject of "judicial distrust" since they "purport[] to evaporate [coverage] in the presence of other insurance." Due to this "judicial distrust", "the modern trend is to require equitable contributions on a pro rata basis from all primary insurers regardless of the type of 'other insurance' clause in their policies." (*Dart Indus., Inc. v. Commercial Union Ins. Co*. (2002) 28 Cal.4th 1059, 1080.)
- And since concurrent insurers do not have contracts with each other, their "respective obligations flow from equitable principles designed to accomplish ultimate justice in the bearing of a specific burden" and are "not controlled by the language of their contracts with the respective policy holders." (*Signal Companies, Inc. v. Harbor Ins. Co.* (1980) 27 Cal.3d 359, 369.)

- There are generally three (3) types of "Other Insurance" clauses:

  - <u>"Pro Rata" Clauses</u> – require insurers to share the loss based on the proportion each of their respective policy limits have in relation to the total amount of coverage available to the insured. (*See, e.g., Am. Cont'l Ins. Co. v. Am. Cas. Co. of Reading, Pa*. (1999) 73 Cal.App.4th 508, 515 ["the company shall not be liable for a greater proportion of such loss than the applicable limit of liability under this policy for such loss bears to the

total applicable limit of liability of all valid and collectible insurance against such loss."].)

- Note: several "pro rata" "other insurance" clauses alternatively allow for "equal shares" payment up to each insurer's respective policy limit in the event all applicable policies provide for "equal shares". (*See, e.g., Shade Foods, Inc. v. Innovative Prod. Sales & Mktg. Inc*. (2000) 78 Cal.App.4th 847, 896 ["If all of the other insurance permits contribution by equal shares, we will follow this method also. Under this approach, each insurer contributes equal amounts until it has paid its applicable limit of insurance or none of the loss remains, whichever comes first."].)

- "Excess Only" Clauses – If there is other valid, collectible insurance, the policy exceeds all other such coverage. (*See, e.g., Am. Cont'l Ins. Co. v. Am. Cas. Co. of Reading, Pa*. (1999) 73 Cal.App.4th 508, 514 ["If there is other insurance which applies to the loss … the other insurance must pay first. It is the intent of this policy to apply to the amount of loss which is more than: [¶] A. the limits of liability of the other insurance; and [¶] B. the total of all deductibles and self-insured amounts under all such other insurance."].)

- "Escape" Clauses – If there is other valid, collectible insurance, the policy with an "escape" clause purports to provide no coverage. (*Dart Indus., Inc. v. Commercial Union Ins. Co*. (2002) 28 Cal. 4th 1059, 1079 ["other insurance" clause "automatically rendered the policy null and void if there was any other insurance covering the same risk"].)

- California courts have developed several, specific legal rules to determine the priority of coverage depending on the type of "other insurance" clause used in competing liability policies:

    - Same Loss – "Other Insurance" clauses only can be used to resolve priority of coverage among multiple policies if they cover the same "loss." (*See Fire Ins. Exch. v. Am. States Ins. Co*. (1995) 39 Cal.App.4th 653, 660 ["[T]he application of 'other insurance' clauses requires, as a foundational element, that there exist multiple policies applicable to the *same loss*."][emphasis in original, citing *Pines of La Jolla Homeowners Assn. v. Indus. Indem*. (1992) 5 Cal.App.4th 714, 723].)
    - Same Level – "Other Insurance" clauses only can be used to resolve priority of coverage so long as the policies provided coverage "level" (i.e. primary policy vs. primary policy, etc.) (*See JPI Westcoast Construction, L.P. v. RJS & Associates, Inc*. (2007) 156 Cal.App.4th 1448, 1460 ["it is a basic rule of California insurance law that 'an 'other insurance' issue can arise only between carriers on the same level of coverage.'"][citing *Carmel Development Co. v. RLI Ins. Co*. (2005) 126 Cal.App.4th 502, 513].)

- Rules to Resolve Conflicts Between Multiple "Other Insurance" Clauses:

    - Conflict between "Pro Rata" and "Excess Only" clauses → "Pro Rata" wins (*See Fireman's Fund Ins. Co. v. Maryland Cas. Co*., *supra,* 65 Cal.App.4th at 1305; *Hartford Case Ins. Co. V. Travelers Indem. Co.* (2003) 110 Cal.App.4th 710, 726);

- Note: earlier California authority held that an "Excess Only" clause prevails over a "Pro Rata" clause. (*See, e.g., Owens Pac. Marine, Inc. v. Ins. Co. of N. Am*. (1970) 12 Cal.App.3d 661, 669). However, current California case law overwhelmingly favors proration. (*See Century Sur. Co. v. United Pac. Ins. Co*. (2003) 109 Cal.App.4th 1246, 1258 [discussing history of issue, explaining that "older opinions, however, do not look to rationale, but rather simply to precedent" and holding "the only proper result is to ignore all of the clauses and require some equitable pro rata apportionment."].)

◦ Conflict between "Pro Rata" and "Escape" clauses → "Pro Rata" wins (*See* Employers *Reinsurance Corp. v. Mission Equities Corp*. (1977) 74 Cal.App.3d 826, 831; *Peerless Cas. Co. v. Continental Cas. Co.* (1956) 144 Cal.App.2d 617, 623);

◦ Conflict between "Excess Only" and "Escape" clauses→ policies pro rate (*See* Commerce *& Industry Ins. Co. v. Chubb Custom Ins. Co* (1999) 75 Cal.App.4th 739, 744; *Continental Cas. Co. v. Pacific Indemnity Co.* (1982) 134 Cal.App.3d 389, 396-397);

- Note: earlier California authority held that an "Excess Only" clause would be enforced as opposed to the "Escape" clause since "Escape" clauses are generally disfavored. (*Employers Reinsurance Corp. v. Mission Equities Corp*. (1977) 74 Cal.App.3d 826, 831);

◦ Conflict between two "Excess Only" clauses → policies pro rate (*See* Travelers *Cas. & Sur. Co. v. American Equity Ins. Co*. (2001) 93

Cal.App.4th 112, 1149-1150; *CSE Ins. Group v. Northbrook Pro. & Cas. Co.* (1994) 23 Cal.App.4th 1839, 1842);

- Conflict between "Escape" and "Escape" → Policies pro rate (See *Fire Ins. Exch. v. American States Ins. Co*. (1995) 39 Cal.App.4th 653, 659.)

- Notes re: "Other Insurance" Clauses And Coverage Under A Memorandum Of Coverage
  - Even though a Memorandum of Coverage can act as a substitute for liability insurance, coverage under a Memorandum of Coverage is not "insurance" – it is a joint risk sharing agreement authorized by statute. (Gov. Code § 990.8(c); *Fort Bragg Unified School Dist. v. Colonial American Casualty & Surety Co*. (2011) 194 Cal.App.4th 891, 904; *Southgate Recreation & Park Dist. v. Cal. Ass'n for Park & Recreation Ins.* (2003) 106 Cal.App.4th 293, 297; *Orange County Water Dist. v. Ass'n of Cal. Water Etc. Auth.* (1977) 54 Cal.App.4th 772, 777.)
  - As a result, the "other insurance" rules discussed above normally do not apply as between a liability policy and a Memorandum of Coverage since a Memorandum of coverage, in essence, is a form of "self-insurance". (*Sch. Excess Liab. Fund v. Westchester Fire Ins. Co.* (2004) 117 Cal.App.4th 1275, 1287; *Orange Cty. Water Dist. v. Ass'n of Cal. Water etc. Auth.* (1997) 54 Cal.App.4th 772, 779; *see also Aerojet-General Corp. v. Transport Indemnity Co.* (1997) 17 Cal.4th 38, 72.)
    - Note: In *Sch. Excess Liab. Fund v. Westchester Fire Ins. Co., supra,* the court rejected the contention that the JPA's extension of coverage to an additional covered party operated to render the JPA an insurer

since the additional covered party was "performing operations by and on behalf of the member district … ." (*Id.* at 1287.)

- Note: At the same time, liability insurers providing coverage for risks specific to public entities have begun to draft "other insurance" clauses which specifically purport to make the liability coverage provided also excess to any coverage provided under a Memorandum of Coverage.

b. Auto Coverage – Insurance Code §11580.9

- In an attempt to simplify priority of coverage issues in cases involving auto liability coverage, Insurance Code §11580.9 sets forth several "conclusive presumptions" via to resolve such disputes:

  ◦ Policies Issued To Persons Engaged In "Business Selling, Repairing, Servicing, Delivering, Testing, Road-Testing, Parking, or Storing Motor Vehicles" ("Selling and Service"):

    - If "one policy affords coverage to a named insured engaged in" motor vehicle "Selling and Service" and "the motor vehicle is being operated by any person engaged in any of these businesses ... the insurance afforded by the policy issued to the person engaged in the business shall be primary, and the insurance afforded by any other policy shall be excess." (Cal. Ins. Code §11580.9(a)(1).)

    - Alternatively, if "the motor vehicle is being operated by any person" not engaged in motor vehicle "Selling and Service" "the insurance afforded by the policy issued to any person engaged in any of these businesses shall be excess over all other insurance

available to the operator as a named insured or otherwise." (Cal. Ins. Code §11580.9(a)(2).

- Policies Issues To Persons Engaged In Business of "Rent[ing] or Leas[ing] Motor Vehicles Without Operators (Cal. Ins. Code §11580.9(b)):

    - Policy issued to named insured in rental/leasing business provides only excess insurance over valid coverage for driver.

    - Requirements: Rented/Leased vehicle must: (1) be a "commercial" vehicle (designed for commercial transport of passengers or property); or (2) have a lease term of "six months or longer."

    - Note: Ins. Code §11580.9(b) can apply even if renting/leasing vehicles is not the named insured's primary occupation. (*See Sentry Select Ins. Co. v. Fid. & Guar. Ins. Co*. (2009) 46 Cal.4th 204, 207.)

- Accident Arises Out Of "Loading Or Unloading" Of A Motor Vehicle: Policy issued to "the owner, tenant, or lessee of the premises on which the loading or unloading occurs" is primary over policy covering the motor vehicle. (Cal. Ins. Code §11580.9(c).)

- Two Or More Policies Apply To Auto Accident And Ins. Code §11580.9(a)-(c) Do Not Apply:

    - Policy which "Describes" or "Rates" the vehicle as an "Owned Auto" is primary. (Cal. Ins. Code §11580.9(d).)

    - "Described" or "Rated" means "particularization" of the vehicle in the policy (i.e. "describe[ing] the [vehicle] as an owned automobile

by reference to the Vehicle Identification Number.") (*Highlands Ins. Co. v. Cont'l Cas. Co*. (9th Cir. 1995) 64 F.3d 514, 519.) Listing a vehicle as "owned" is insufficient. (*Ohio Cas. Ins. Co. v. Aetna Ins. Co*. (1975) 85 Cal.App.3d 521, 523.) Also, an excess or umbrella policy which incorporates by reference a primary policy "describing" or "rating" a vehicle does not thereby "describe" or "rate" the vehicle under the excess or umbrella policy for purposes of Insurance Code §11580.9(d). (*See Hartford Accident & Indem. Co. v. Sequoia Ins. Co*. (1989) 211 Cal.App.3d 1285, 1300.)

- If multiple policies "describe" or "rate" a vehicle consisting of a combination tractor/tractor trailer rig, all such policies are primary. (*Wilshire Ins. Co. v. Sentry Select Ins. Co*. (2004) 124 Cal.App.4th 27, 35.)

- Note: Insurance Code §11580.9(d) can apply even if one or more of the applicable policies is not an auto policy. (*Scottsdale Ins. Co. v. State Farm Mut. Auto. Ins. Co*. (2005) 130 Cal.App.4th 890, 903 ["In determining whether section 11580.9, subdivision (d), applies, the deciding factor is not the type of policy involved but whether it affords valid and collectible liability insurance that applies to the motor vehicle involved in the accident."].)

- Note: Some excess/umbrella policies, in scheduling underlying primary policies may describe an owned vehicle without providing its Vehicle Identification Number on its Schedule of Underlying

Insurance (e.g. "1987 Ford Bronco".) The issue of whether this constitutes "describing" or "rating" the vehicle for purposes of Insurance Code §11580.9(d) is currently before the Fourth Appellate District in *Mercury Ins. Co. v. Chartis Property Cas. Co.*, Case no. G054369.

- Note: If two or more policies covering auto liability specifically provide "excess" coverage, normal "other insurance" clause rules apply. (*CSE Ins. Grp. v. Northbrook Prop. & Cas. Co*. (1994) 23 Cal.App.4th 1839, 1844 [§11580.9(d) rules did not apply to resolve priority of coverage between two umbrella carriers].)

◦ Sharing Of Defense Costs Between Personal Primary And Personal Excess Auto Carriers:

If indemnification of an accident requires payment by both a "personal" (i.e. non-commercial) primary and "personal" excess auto carrier, each carrier shall pay defense costs in proportion to their payment of damages. (Cal. Ins. Code §11580.9(g).)

◦ Hypothetical Example: (1) Public employee gets into accident while driving their own vehicle; (2) Public employee has both primary and personal excess auto coverage; and (3) Public entity is covered under a Memorandum of Coverage for the first $1 million.

- First General Rule: Under general principals of insurance law, where multiple policies apply to the same persons or organization liable for a loss, the determination of priority "requires the following steps: (1) the determination of the person upon whom ultimate liability will be thrust

by the legal principals of indemnity; and (2) the determination by analysis of the insurance policies involved of the extent of the coverage afforded by those policies to that person." (*Transport Indem. Co. v. Am. Fid. & Cas. Co.* (1970) 4 Cal.App.3d 950, 956.)

- Rules Applicable To Liability Of Public Employees:

  - When an employee of a public entity requests his or her public entity employer to provide a defense and indemnification for a lawsuit arising from an act or omission within the course and scope of employment, Government Code §§ 825, 825.4 and 996.4 require the entity to pay for the defense of the lawsuit and for any judgment or settlement against the employee. (*See e.g., C.A. v. William S. Hart Union High Sch. Dist*. (2012) 53 Cal.4th 861, 869 n.2 [citing Govt. Code §§ 825, 825.4 and 996.4 and explaining that "[e]ven when the individual public employee is sued for negligence … the defense costs and any compensatory damages will ordinarily be paid by the employer, as a public employee sued for injuries arising out of negligent acts or omissions within the scope of his or her employment is generally entitled to a defense and indemnity by the public entity."].)

    - Also, a vehicle owner has a right of indemnity against a permissive user under the provisions of Vehicle Code §17153. (*Am. Motorists Ins. v. Underwriters at Lloyd's London* (1964)

224 Cal.App.2d 81, 86-87; *Hartford Accident & Indem. Co. v. Transport Indem. Co.* (1966) 242 Cal.App.2d 90, 94-95.)

- At the same time, the public entity can fulfill its obligation through "*any* insurance policy." (*Govt. Employees Ins. Co. v. Gibraltar Cas. Co.* (1986) 184 Cal.App.3d 163, 167 [italics in original].)

  - Since personal automobile policies typically contain language providing coverage to the named insured and "any other person or organization for his or its liability because of the acts or omissions of any insured", public entity can qualify as an "insured" under the employee's personal auto policy. (*Govt. Employees Ins. Co.*, *supra,* 184 Cal.App.3d at 171; *Younker*, *supra*, 233 Cal.App.3d at 1328-29; *Oxnard Union High Sch. v. Teachers Ins. Co.* (1971) 20 Cal.App.3d 842, 844-45.)

  - Note: With respect to other types of personal liability policies, one court has held that unless the express language of the employee's personal policy provides insured status to the public entity, the public entity's insurer cannot seek contribution for defense costs from the employee's personal insurer because: (1) the Government Code makes the public entity primarily liable for providing a defense to the employee; and (2) the employee's personal insurer can assert the employee's rights against the public entity and its insurer via subrogation. (*See Pac. Indem. Co. v. Am. Mut. Ins. Co*. (1972)

28 Cal.App.3d 983, 992 [liability insurer for Regents could not seek contribution from insurer providing professional liability coverage to employee surgeon where it was not demonstrated that Regents of the University of California were also insured under employee's professional liability policy].)

- Intermediate Conclusion: (1) The public entity is the person with "ultimate liability" since it will be responsible under the Government and Vehicle Code to defend and indemnify the employee; and (2) The public entity will likely qualify as an "insured" under the employee's personal auto policy as a person liable "because of the acts or omissions of any insured".
- Priority Of Coverage Analysis: Employee's personal auto policy is primary under Cal. Ins. Code §11580.9(d) if that policy, as is typical**,** "describes" or "rates" the vehicle. The employee's personal excess policy would come second since: (1) the personal excess policy would attach after the exhaustion of the primary auto policy; and (2) its "other insurance" clause would normally not apply to make it excess over the public entity's Memorandum of Coverage since that coverage is not "insurance." The Memorandum of Coverage would be third, followed by any excess coverage procured by the public entity and specifically written above the Memorandum of Coverage.

c. Potential Effect Of Contractual Indemnity Provisions On Priority Of Coverage

- When two parties have contracted for indemnity between them in relation to a certain risk or activity (construction contractor/subcontractor; lessor/lessee, etc.),

the contractual indemnity obligation can control the priority of coverage between their respective liability policies. This rule applies notwithstanding the "other insurance" clauses in their respective policies. The rule is designed to preserve the "risk sharing" allocation in the contractual indemnity provision. (*See Rossmoor Sanitation, Inc. v. Pylon, Inc.* (1975) 13 Cal.3d 622, 634-635.)

- ° Note: Work/lease contracts with indemnity provisions do not qualify as "insurance" because the "principle object and purpose" of the work/lease contract is not to provide risk shifting/distribution between the parties, even though the indemnity provision serves that function. (*See Truta v. Avis Rent A Car Sys., Inc*. (1987) 193 Cal.App.3d 802, 812, *superseded in part via statute as stated in Schnall v. Hertz Corp*. (2000) 78 Cal.App.4th 1144, 1155 n.5 [rental car agreement which provided that rental agency would bear costs for property damage for an additional fee was not "insurance" notwithstanding fact that agreement shifted loss distribution between the parties because the "principle object and purpose" of transaction was to rent vehicle]; *see also Heckart v. A-1 Self Storage, Inc*. (2015) 243 Cal.App.4th 525 (2015), *review granted and opinion superseded sub nom. Heckart v. A-1 Self Storage* (Cal. 2016) 366 P.3d 988 [following *Truta* and reaching same conclusion with respect to storage unit rental contract].)
- ° Note: While indemnity provisions in work/lease contracts are not "insurance" and are not interpreted by the same rules which govern insurance contracts, similar rules apply with respect to the defense obligations under an indemnity agreement. Specifically, unless the

indemnity provision expressly states otherwise, the contractual indemnitor is obligated upon request to provide the contractual indemnitee a defense against all claims which are "embraced by the indemnity." (*See Crawford v. Weather Shield Mfg. Inc*. (2008) 44 Cal.4th 541, 557; Cal. Civ. Code §2778(4).)

- This rule does not apply to a priority of coverage dispute between a primary and excess carrier. (*See Reliance Nat. Indem. Co. v. Gen. Star Indem. Co*. (1999) 72 Cal.App.4th 1063, 1081-1083.)

- **<u>Hypothetical Examples</u>:**

  - Public entity enters into construction contract with general contractor for construction of new facilities. Construction contract requires general contractor to defend and indemnify public entity for bodily injury arising out of the construction activity. A subcontractor's employee suffers bodily injury and sues both general contractor and the public entity. If the bodily injury falls within the scope of the general contractor's indemnity obligation to the public entity, the liability policy for general contractor would be primary to liability policy issued to public entity.
  - Same facts, but primary and excess carrier for general contractor fund settlement on behalf of both general contractor and public entity and primary carrier for the public entity also funds a portion of the settlement on behalf of the public entity. Primary carrier for public entity cannot obtain reimbursement from excess carrier for general contractor since shifting of risks under contractual indemnity agreement does not

overcome normal priority of coverage between primary and excess policies.

C. Duties – Or Lack Thereof – Between Multiple Carriers

- Unlike some other jurisdictions, primary and excess carriers in California have no legal duties towards each other. Rather, each insurer has its own separate, contractual duties towards the insured(s) based on their own separate contracts. (*Commercial Union Assurance Companies v. Safeway Stores, Inc*. (1980) 26 Cal.3d 912, 917.)

- A defending/settling primary carrier can sue for equitable contribution from any non-defending/non-settling primary carrier(s) in order to equitably apportion the loss. (*See* Civ. Code §1432 ["a party to a joint, or joint and several obligation, who satisfies more than his share of the claim against all, may require a proportionate contribution from all the parties joined with him."]; *see also American Continental Ins. Co. v. American Cas. Co. of Reading, Pa.* (1999) 73 Cal.App.4th 508, 513.)

  ◦ Note: There is no right to contribution between insurers providing coverage for different insureds. (*Golden Eagle Ins. Co. v. Ins. Co. of the West* (2002) 99 Cal.App.4th 837, 853.)

- There is no right of equitable contribution between insurance carriers providing different levels of coverage (i.e. between a primary carrier and an excess carrier.) (*Reliance Nat'l Indem. Co. v. General Star Indem. Co.* (1999) 72 Cal.App.4th 1063, 1078.) However: (1) if a primary carrier breaches its defense/settlement duties towards the insured and the excess carrier satisfies these obligations; or (2) if an excess carrier breaches its defense/settlement duties towards the insured –

the carrier which fulfilled the obligation can sue the carrier which did not fulfill its obligations via equitable subrogation (i.e. the performing carrier "stands in the shoes" of the insured). (*See Safeway Stores, Inc*., *supra,* 26 Cal.3d 912, 917; *Fireman's Fund Ins. Co. v. Maryland Cas. Co*. (1994) 21 Cal.App.4th 1586, 1601.)

° Split Of Authority: California case law authority is divided on whether an excess carrier can sue a primary carrier via subrogation in the absence of an excess judgment. Several cases have held that absent an excess judgment, the insured (and by extension the excess carrier) cannot show that the insured suffered damage by the primary carrier's failure to settle within the primary policy limit. (*See RLI Ins. Co. v. CNA Cas. of California* (2006) 141 Cal.App.4th 75, 81.) Other cases have held the excess carrier could sue the primary carrier via subrogation for a settlement which invades the excess layer if the excess carrier shows that the primary carrier unreasonably failed to settle the matter within the primary policy limit. (*Fortman v. Safeco Ins. Co*. (1990) 221 Cal.App.3d 1394, 1401.) The most recent case authority indicates that an excess judgment is not required so long as the excess carrier can prove that it would not have had to contribute to the settlement had the primary carrier unreasonably failed to settle within the primary policy limit. (*Ace Am. Ins. Co. v. Fireman's Fund Ins. Co*. (2016) 2 Cal.App.5th 159, 168-183 [following *Fortman* after detailed discussion of division in authority]; *Starr Indem. & Liab. Co. v. Old Republic Gen. Ins*. (Cal.Ct.App. 2016) 2016 WL 6247678, at *1 [unpublished case following *Ace. Am., supra*].)

- Practical Application: Due to this split in California authority, in a case where a primary carrier has unreasonably failed to settle within the primary limit, whether or not the excess carrier would be willing to settle within the excess layer and pursue the primary carrier or, alternatively, would prefer that the case to proceed through trial in order to obtain an excess judgment may depend on which appellate district the case would be in or whether an intra-insurer action is removable to federal court. If the coverage case would be in the California Second District, Division Five (*RLI, supra*), the excess carrier may find it advisable to proceed through trial. However, if the case would be in the Second District, Division One (*Fortman, supra*), Division Three (*Twentieth Century-Fox Film Corp. v. Harbor Ins. Co*. (1978) 85 Cal.App.3d 105, 111), Division Four (*Ace American*, *supra*) or the Fourth District (*Camelot by the Bay Condo. Owners' Assn. v. Scottsdale Ins. Co*. (1994) 27 Cal.App.4th 33, 46), the excess carrier may agree to settle the matter and then file an intra-insurer subrogation action against the primary carrier. If the case is removable to federal court, the situation is even more uncertain since *published* Ninth Circuit authority follows the *RLI* rule (*Mercado v. Allstate Ins. Co*. (9th Cir. 2003) 340 F.3d 824, 827), but more recent *unpublished* Ninth Circuit authority has followed the *Fortman* rule. (*See RSUI Indem. Co. v. Discover P & C Ins. Co*. (9th Cir. 2016) 649 F.App'x 534, 537.)

- **Issues re “Gaps” Between Coverage Layers**: If there is a “gap” in coverage between the primary and excess coverage layers due to the error of an insurance agent and the primary carrier pays for the “gap”, a carrier which pays for the

"gap" can sue the agent based on principles of equitable subrogation (i.e. the paying carrier "stands in the shoes" of the insured's for purposes of the malpractice claim against the insurance agent.) (*See Troost v. Estate of DeBoer* (1984) 155 Cal.App.3d 289, 295.)

- ° Practical Example: Coverage under a Memorandum of Coverage may have lower sublimits which apply to certain, specified risks or group limits which may have become partially or completely exhausted. If the excess policy is not written to "drop down" and apply upon exhaustion of the sublimits/exhausted group limits, the excess carrier has the ability to: (1) pay the coverage "gap' in settlement and (2) sue whoever is responsible for negligently creating the gap in coverage to seek reimbursement.

D. Division Of Responsibility Between Multiple Carriers

1. Duties To Provide/Conduct A Defense

- Unless the excess/umbrella polices provides otherwise, the primary insurer or insurers owe the exclusive duty to defend the insured until the primary coverage is exhausted or otherwise is not on the risk. (*Signal Companies, Inc. v. Harbor Ins. Co*. (1980) 27 Cal. 3d 359, 368 ["where there is excess coverage, whether by virtue of an excess clause in one policy or otherwise, it is the primary insurer which is solely liable for the costs of defense if the judgment does not exceed primary coverage."].) The same rule applies even if the value of the claim exceeds the available, primary indemnity limit(s). (*Id.*)

  - ° Excess policies often give the excess carrier the *option* to provide/associate in with the defense.

- However, the excess carrier is not required to do anything in relation to the defense until its contractual defense duties are implicated. As a result, while the insured is being defended by a primary carrier, the excess carrier is not required to issue a reservation of rights and is not estopped from asserting coverage defenses due to its failure to issue a reservation of rights. (*See State Farm Fire & Cas. Co. v. Jioras* (1994) 24 Cal.App.4th 1619, 1626; *Phoenix Ins. Co. v. United States Fire Ins. Co*. (1987) 189 Cal.App.3d 1511, 1528.)

- After the primary carrier has paid its applicable policy limit, if the excess carrier fails to assume the defense and the primary carrier continues to defend, it can seek reimbursement for defense costs from the excess carrier based on subrogation principles. (*See Aetna Cas. & Sur. Co. v. Certain Underwriters* (1976) 56 Cal.App.3d 791, 804.)

2. Additional Issues Re: Deductibles And Self Insured Retentions (SIRs):

- Unless the language of the policy expressly states otherwise, any policy deductible does not apply to defense costs payable under the policy – it applies only to the policy indemnity limit. (*See Forecast Homes, Inc. v. Steadfast Ins. Co.* (2010) 181 Cal.App.4th 1466, 1473; *Gen. Star Nat. Ins. Corp. v. World Oil Co*. (C.D.Cal. 1997) 973 F.Supp. 943, 948.)

- In contrast, an SIR "refers to a specific sum or percentage of loss that is the insured's initial responsibility and must be satisfied before there is any coverage under the policy" and usually "applies to defense costs and settlement of any claim." (*Forecast Homes*, *supra,* 181 Cal.App.4th 1466, 1474.) In this respect, a SIR can make a primary policy function like an

excess policy if the language of the policy indicates it must be exhausted prior to defense or indemnity coverage attaching. (*Id.*)

- ◦ However, absent express language applying the SIR to defense costs, an SIR provision will not prevent the defense duty from attaching immediately under a primary policy with an SIR. (*See, e.g., Am. Safety Indem. Co. v. Admiral Ins. Co*. (2013) 220 Cal.App.4th 1, 13 [duty to defend immediately applied where policy language did not "expressly and unambiguously make its duty to defend the Horton entities subject to the SIR"].)
- ◦ Also, unless the policy language expressly states otherwise, an SIR obligation can be satisfied by other insurance coverage and/or by payments by a co-insured. (*Forecast Homes*, *supra,* 181 Cal.App.4th 1466, 1474; *Vons Companies, Inc. v. United States Fire Ins. Co*. (2000) 78 Cal.App.4th 52, 63.)
  - At the same time, an SIR on a primary policy does not require an excess carrier to "drop down" and provide a defense prior to SIR exhaustion because "[a]n excess insurer could end up defending a claim before the primary insurer had an obligation to defend that claim! Reasonable insureds don't expect to receive a defense from a typically much cheaper excess policy unless all the expensive primary insurance they bought has been exhausted." (*Padilla Const. Co. v. Transportation Ins. Co*. (2007) 150 Cal.App.4th 984, 989.)
- ◦ Furthermore, unless the policy expressly states otherwise, multiple SIRs from multiple policies cannot be "stacked" to prevent the defense duty

from attaching since SIRs are not "insurance." (*See Montgomery Ward & Co., Inc. v. Imperial Cas. & Indem. Co*. (2000) 81 Cal.App.4th 356, 360.)

3. Notice Issues In Relation To Excess Coverage And Resinsurance

a. <u>California Notice Requirements</u>

- Even if an excess carrier's defense obligations are not implicated while a primary carrier is providing a defense, many excess policies require the insured to provide written notice to the excess carrier of claims or lawsuits which "appear likely" to "involve" the excess policy.
- While the excess policy may contain formal notice or tender procedures, California applies a "constructive notice" standard – there is sufficient notice to the excess insurer if it has notice of facts which would put an reasonable excess insurer on notice that it should inquire further. (*See Span, Inc. v. Associated Internat. Ins. Co*. (1991) 227 Cal.App.3d 463, 482 [excess carrier had constructive notice that its coverage was potentially implicated where: (1) it knew an underlying action had been filed against the insured; (2) it knew the primary carrier was insolvent; and (3) review of the litigation would have revealed that the demand was in excess of primary limits],)
- There can be "constructive notice" when one insured tenders an action in which another insured is a defendant. (*See California Shoppers, Inc. v. Royal Globe Ins. Co*. (1985) 175 Cal.App.3d 1, 37 [submission of complaint by named insured who was not a defendant in the case was constructive notice since carrier should have made inquiries which, if done so, would have alerted it to the fact that another insured was named as a

defendant in the same action].) As a result, under a Memorandum of Coverage providing insured status to multiple public entities, tender by one entity to an excess carrier may provide "constructive notice" of other insured public entities involved in the same matter.

- Notwithstanding the "constructive notice" rule, it is always recommended to follow the policy's stated notice procedures as closely as possible to avoid notice disputes. Also, late notice may prevent an insured from obtaining reimbursement for pre-notice defense costs by operation of the "no-voluntary payments" provision. (*See, e.g., Insua v. Scottsdale Ins. Co*. (2002) 104 Cal. App. 4th 737, 743; *Tradewinds Escrow, Inc. v. Truck Ins. Exch*. (2002) 97 Cal.App.4th 704, 710.)

b. <u>Late Notice Issues</u>

- Late notice to an excess carrier generally will not preclude coverage under an "occurrence"-based excess policy unless the lack of earlier notice caused "actual", "substantial prejudice" to the excess carrier. (*See Shell Oil Co. v. Winterthur Swiss Ins. Co*. (1993) 12 Cal.App.4th 715, 761-763; *Sequoia Ins. Co. v. Royal Ins. Co. of Am*. (9th Cir. 1992) 971 F.2d 1385, 1394; *see also Providence Washington Ins. Co. v. Container Freight, Inc*. (1997) 68 Cal.Rptr.2d 776 [depublished case applying modified rule focusing on "the fundamental issue" of "whether the insured acted reasonably in withholding notice until it was given"].)
- Also, if the excess carrier is on inquiry notice of the relevant facts, such notice can satisfy the excess policy's notice requirements. (See *Span, Inc. v. Associated Internat. Ins. Co*. (1991) 227 Cal. App. 3d 463, 482

[adequate inquiry notice to excess insurer where insurer had notice of pending action against insured and of the primary carrier's insolvency].)

- At the same time, some excess policies require notice of certain, specific claims or types of injuries which will likely implicate the excess coverage layer (*e.g*., wrongful death, sexual molestation, etc.) While these specific reporting requirements would not necessarily avoid the "notice-prejudice" rule for excess carriers, they may make is easier for an excess carrier to show prejudice by indicating what additional actions the excess carrier may have done upon prior notice of such a claim.
- Also, substantial delay by an excess insurer in asserting a late notice defense can act as a waiver of the defense. (*See Nat'l Am. Ins. Co. of California v. Certain* Underwriters *at Lloyd's London* (9th Cir. 1996) 93 F.3d 529, 538 [two year delay in asserting late notice defense resulted in waiver]; *Ellgass v. Bhd. of R. R. Trainmen Ins. Dep't, Inc*. (9th Cir. 1965) 342 F.2d 1, 3 [twelve-month delay resulted in waiver]; *see also* Cal. Ins. Code § 554 ["Delay in the presentation to an insurer of notice or proof of loss is waived, if caused by an act of his, or if he omits to make objection promptly and specifically upon that ground."].)
- Similarly, a denial of coverage by the liability carrier on substantive grounds waives any late notice defense since the carrier essentially saying that they would not have provided coverage even if it had received timely notice. (*See Shell Oil Co. v. Winterthur Swiss Ins. Co*. (1993) 12 Cal.App.4th 715, 762; *Eichler Homes, Inc. v. Underwriters at Lloyd's,*

London (1965) 238 Cal.App.2d 532, 539; *Comunale v. Traders & Gen. Ins. Co*. (1953) 116 Cal.App.2d 198.)

- Since the rights between a primary carrier and an excess carrier arise via subrogation (i.e. by each insurer "standing in the shoes" of the insured), a primary carrier suing an excess carrier via subrogation is subject to the defense that the excess carrier did not receive sufficient notice of its excess exposure. (*See Sequoia Ins. Co. v. Royal Ins. Co. of Am*. (9th Cir. 1992) 971 F.2d 1385, 1393.) Again, since the "notice prejudice" rule applies, the excess carrier has to show that had it received sufficient notice from the primary carrier/insured, it would have been able to resolve the matter for a lesser amount.
  - Illustration: Settlement offer is close to but within the primary policy limit and primary carrier both fails to advise excess carrier of the settlement offer and to accept the offer. Since the excess carrier could have "assisted" the primary carrier "in evaluating the claim" and "encouraged settlement within the policy limits", the excess carrier has a late notice/breach of cooperation clause defense in any subsequent intra-insurer litigation between the primary and excess carrier. (*Sequoia Ins. Co., supra.*)
- Unlike under excess policies, an insured generally has no notice obligations towards a reinsurer – the ceding insurer has the notice obligations towards the reinsurer. At the same time, a reinsurer must show substantial prejudice under the "notice prejudice" rule to avoid coverage based on lack of notice. (*See Nat'l Am. Ins. Co. of California, supra,* 93

F.3d 529, 538; *Ins. Co. of State of Pennsylvania v. Associated Int'l Ins. Co.* (9th Cir. 1990) 922 F.2d 516, 523.) Moreover, the Ninth Circuit has held that if the reinsurer denies liability, there is a "strong presumption" that it suffered no prejudice since it is "merely deny[ing] coverage at a later date." (*Nat'l Am. Ins. Co., supra,* 93 F.3d 529, 538.)

4. Duties In Relation To Settlement

- The primary carrier, as the entity with the right and obligation to conduct and control the defense, has the corresponding duty to keep the insured reasonably apprised of settlement discussions/opportunities. This includes a duty to advise the insured of settlement demands in excess of the primary limit when there is a significant risk of excess liability so that the insured can protect its own interests. (*See Martin v. Hartford Acc. & Indem. Co.* (1964) 228 Cal.App.2d 178, 184 [primary carrier "had the duty to communicate to [the insured] the results of any investigation indicating liability in excess of the policy limits, and any offers of settlement which were made so that [the insured] might take proper steps to protect [their own] interest."].)
    - Note: This situation can create an actual conflict of interest also requiring the insurer to provide independent counsel if the insured is potentially willing to pay the excess since the primary insurer's interest would be to defend the case and potentially avoid paying its entire primary limit. (*See Anguiano v. Allstate Ins. Co*. (9th Cir. 2000) 209 F.3d 1167, 1169; *Merritt v. Reserve Ins. Co*. (1973) 34 Cal.App.3d 858, 876.)
- Because the primary carrier has the right and obligation to conduct and control the defense, the primary carrier has the right to control settlement negotiations. (*See*

Diamond Heights Homeowners Assn. v. Nat'l Am. Ins. Co. (1991) 227 Cal.App.3d 563, 577; *Fuller-Austin Insulation Co. v. Highlands Ins. Co*. (2006) 135 Cal.App.4th 958, 986.) As a corollary of this rule, the primary carrier can negotiate a "reasonable", "good faith" settlement which invades the excess layer of coverage. (*Id.*)

° Example: In *Diamond Heights, supra,* an insured developer had been sued for construction defects. Its primary insurer provided a defense and also notified the excess carrier that settlement demands exceeded primary coverage and it was likely that the primary policy limits would be exhausted. (*Id.*, 569-570.) The primary carrier subsequently notified the excess carrier that the settlement demand prior to trial exceeded the primary limits. However, the excess carrier only offered a "a nominal sum" towards settlement. (*Id.*, 570.) The case then was settled on the first day of trial by the primary carrier over the excess carrier's objection via a stipulated judgment invading the excess layer, cash payments representing the remaining primary coverage limits and an assignment of rights to the third party claimant of the insured's rights against the non-contributing excess carrier. (*Id.*) Because the settlement was reasonable and the excess carrier had adequate notice of the excess settlement and could have assumed the insured's defense, the excess carrier waived its right to rely on the "no action" provision in the excess policy to avoid coverage for the settlement. (*Id.*, 580.)

° Example: In *Fuller-Austin Insulation*, an asbestos installation company filed an action against 20 of its excess carriers to establish coverage for

past, pending and future asbestos claims. (*Id.*, 966-968.) While the coverage action was pending, the insured filed for bankruptcy and invited the excess carriers to participate in settlement discussions about forming a bankruptcy plan to resolve asbestos claims, a plan in which the majority of excess carried declined to participate. (*Id.*, 968-969.) After the bankruptcy plan was approved and the coverage action was resumed, several excess carriers sought to avoid coverage on the grounds that they did not approve the plan. Following *Diamond Heights,* the court rejected the argument, explaining "[w]e do not believe that the policies can be read to permit an excess insurer to hover in the background of critical settlement negotiations and thereafter resist all responsibility on the basis of lack of consent." (*Id.*, 990-991.) At the same time, the excess carriers were allowed on remand to argue they should not be bound to the Plan terms because "the Plan is unfair, unreasonable or the product of fraud or collusion." (*Id.,* 991

- If the excess carrier wants to challenge the proposed settlement, it can: (1) assume the insured defense after the primary carrier tenders its primary policy limit; or (2) seek a judicial determination that the settlement is not "reasonable" (i.e. the settlement is "unreasonable" and/or the product of "fraud or collusion".) (*Diamond Heights, supra,* 227 Cal.App.3d 563, 582; *Exec. Risk Indem., Inc. v. Jones* (2009) 171 Cal.App.4th 319, 332.)
- Note: Since each insurance carrier owes a separate duty of good faith to the insured, including the duty to accept reasonable settlements within their respective policy limits, an excess carrier can be liable for breach of

the implied covenant where: (1) the settlement is reasonable; (2) the settlement is within the excess layer; and (3) the primary carrier agrees to tender its limits in settlement. (*See Kelley v. British Commercial Ins. Co*. (1963) 221 Cal.App.2d 554, 563.) Similarly, a primary carrier can be liable for unreasonably failing to settle where: (1) there was a settlement demand within the combined, total coverage limits; and (2) it did not reasonably respond to the settlement demand (i.e. tendering the full primary limit.) (*See Howard v. Am. Nat. Fire Ins. Co*. (2010) 187 Cal.App.4th 498, 525 [explaining California law "cannot excuse one insurer for refusing to tender its policy limits simply because other insurers likewise acted in bad faith. If this were not the case, insurers on the risk could simply all act in bad faith, thus immunizing themselves from bad faith liability."].)

- Illustrations:
  - Three (3) primary carriers each provide a $1 million limit for combined, total indemnity limits of $3 million. Settlement demand is $1.5 million. While settlement demand is in excess of each primary carrier's individual limit, each carrier is required to "reasonably respond" to the settlement demand since the demand is within the $3 million combined limits. (*See Howard, supra*.)
  - Primary carrier provides $1 million limit and excess carrier provides $5 million limit for combined total of $6 million. Settlement demand is $2 million. If settlement is reasonable and settlement does not occur because primary carrier does not tender

its full limit, primary carrier can be held liable for breach of the implied covenant. As a result, if excess judgment is entered for $3 million, excess carrier can sue primary carrier for $1 million in reimbursement since, if the case had settled earlier, the excess carrier would have paid $1 million rather than $2 million. (*See Howard, supra*.)

- Same facts, but primary carrier tenders full $1 million limit and the settlement does not occur because the excess carrier refuses to fund the remaining $1 million or assume the defense. Primary carrier can fund the entire settlement over the excess carrier's objection and seek reimbursement for the additional $1 million paid in settlement. (*See Kelley, supra*; *Diamond Heights, supra*.)
- As a corollary of these rules, while a primary carrier has no express legal duties towards the excess carrier, its own duties of good faith towards the insured in relation to settlement and its potential "standing in the shoes" of the insured can require the primary carrier to provide sufficient notice of potential excess exposure to the excess carrier and to tender its primary limits in situations where a "reasonable" settlement demand is in excess of the primary limit. (*Sequoia Ins. Co., supra.*; *Howard, supra*.)
- Additional issues can arise where the excess carrier is not objecting to the "reasonableness" of the entire settlement *per se*, but to recitals in the settlement which, if taken as true, would affect the amount of excess coverage available:

- Example: Insured hospital has: (1) primary malpractice limits of $200,000 per person, $1 million per occurrence and $1 million aggregate; and (2) excess limits of $400,000 per person, $2 million aggregate and $2 million aggregate. Insured/primary carrier settles fourteen (14) malpractice claims and assigns thirteen (13) of these claims to a single year, so that the $1 million aggregate layer is exhausted and excess coverage is implicated. (*Kaiser Found. Hosps. v. N. Star Reinsurance Corp*. (1979) 90 Cal.App.3d 786, 788-789.)

- In such cases, the excess carrier can challenge the allocations based on the theory that the insured colluded with the primary carrier and thereby breached their contractual duties towards the excess carrier. (*See Kaiser Found. Hosps., supra,* 90 Cal.App.3d 786, 792-793 [excess carrier was not bound by loss allocations to certain policy periods agreed to by insured and primary carrier and could challenge factual basis for allocations in intra-insurer coverage litigation between primary and excess carrier]; *see also Andrade v. Jennings* (1997) 54 Cal.App.4th 307, 328 [excess carrier avoided providing coverage for $1.5 million stipulated judgement based on proof that insured breached good faith and cooperation duties by entering into collusive settlement with claimant].)

- Similarly, a reinsurer can avoid its obligations upon proof that the settlement was the product of fraud and/or collusion between the ceding insurer and the insured. (*See Zenith, supra*, 148 Cal.App.4th 998, 1007 ["*Absent fraud or collusion with the insured*, the reinsurer must 'follow

the fortunes' of the ceding insurer on any claims under the policy"][emphasis added]; *see also Pac. Mut. Life Ins. Co. of Cal. v. Pac. Sur. Co*. (1924) 69 Cal.App. 730, 736 ["while a reinsuring company operating under a contract containing an adjustment clause such as the one above quoted may not avail itself of defenses based upon matters arising on or after the occurrence of the disaster which created the liability, it may attack the settlement for fraud or collusion"].)

E. **<u>Requirements For Exhaustion Of Coverage – Transfer Of Responsibility Between Difference Carriers</u>**

- Generally speaking, primary coverage is "exhausted" and excess coverage attaches when the primary indemnity limits have been paid out in settlement(s) and/or to satisfy judgement(s). (*Signal Companies, Inc. v. Harbor Ins. Co*. (1980) 27 Cal.3d 359, 365; *Travelers Cas. & Sur. Co. v. Transcon. Ins. Co*. (2004) 122 Cal.App.4th 949, 952 n.3.) As a result, a primary carrier cannot "exhaust" its limits simply by tendering them to the insured or excess carrier. (*Chubb/Pac. Indem. Grp. v. Ins. Co. of N. Am*. (1987) 188 Cal.App.3d 691, 698.)

  ° <u>Example</u>: In *Hartford Accident & Indem. Co. v. Superior Court* (1994) 23 Cal.App.4th 1774, the primary carrier was defending the insured against more than 66 private actions brought by more than 2,500 plaintiffs based on its alleged "deliberate distribution of toxic chemicals (dioxins) on various dirt roads and horse arenas in the State of Missouri." (*Id.*, 1777.) After paying $4.1 million in settlement, the primary carrier claimed the applicable primary limits were exhausted and asked the excess carriers to assume the defense, which they refused to do so. (*Id.*, 1777-1778.) The exhaustion issue turned on how many "occurrences" there were since six

(6) of the policies had a $300,000 per occurrence limit but no aggregate limit. (*Id.*, 1778.) The primary carrier withdrew from the defense and the excess carriers obtained summary adjudication that the withdrawal was wrongful since there had been no ruling that the primary carrier limits had been exhausted in the coverage action. (*Id.*). The Court of Appeal upheld the ruling, stating that "[w]hen a dispute arises over exhaustion of policy limits, a primary insurer must defend until it obtains a declaratory judgment or summary judgment that it has exhausted its policy limits." (*Id.*)

- Example: In *Hartford Acc. & Indem. Co. v. Cont'l Nat. Am. Ins. Companies* (9th Cir. 1988) 861 F.2d 1184, an employee for Mariposa county killed three (3) secret service agents in an auto accident, which resulted in wrongful death litigation against Mariposa County. The county had a $100,000 primary insurance policy with Hartford and a $5 million excess policy with Transcontinental. The primary policy language stated that Hartford's "payment of the Liability Insurance limit ends our duty to defend or settle." Some three (3) weeks after the accident, Hartford conceded liability to the full extent of its primary limit and asked Transcontinental to assume the defense, which it declined to do. Hartford continued to defend until the case settled for $4 million. Hartford then sued Transcontinental for reimbursement of defense costs. The district court granted summary judgment in favor of Transcontinental and the Ninth Circuit affirmed, concluding that Hartford's ceding of its primary limits to the excess carrier did not constitute "payment" of the limits.

While recognizing “that it may appear unfair to allow an excess insurer to force a primary insurer to pay the costs of defense when it is fairly obvious that the lion's share of the eventual settlement or judgment would come out of the excess insurer's pocket,” it emphasized that it could not “ignore” California case law indicating that primary exhaustion occurred “only by actual settlement or payment of judgement.” (*Id.*, 1186.)

- As indicated above, while umbrella coverage often acts as excess coverage, it can be required to “drop down” and provide primary defense coverage if the umbrella policy provides coverage for claim(s) that the primary policy does not.
- Example: In *Legacy Vulcan Corp. v. Superior Court* (2010) 185 Cal.App.4th 677, an insurer issues an “an Excess Catastrophe Liability Policy” which, in addition to providing excess coverage for “ultimate net loss in excess of the retained limit”, also promised to provide a defense against any lawsuit “seeking damages on account of [] personal injury, property damage or advertising injury” if such injury was “not within the terms of the coverage of underlying insurance but within the terms of coverage of this insurance[.]” (*Id.*, 682-683.) The court ruled this defense coverage “constituted primary coverage” to which the normal rules of primary coverage applied (i.e. immediate defense duty, etc.) (*Id.*, 692-697.)
- Whether or not an excess policy “drops down” and immediately provides coverage upon exhaustion of a scheduled, primary policy depends on the insuring language in the excess policy.

- If the excess policy is written to provide coverage upon exhaustion of specified, scheduled primary insurance, the excess policy applies upon the exhaustion of the scheduled underlying coverage even if there is other primary liability coverage available. (*See, e.g., Travelers Cas. & Sur. Co. v. Transcon. Ins. Co.* (2004) 122 Cal.App.4th 949, 959; *20th Century Ins. Co. v. Liberty Mut. Ins. Co*. (9th Cir. 1992) 965 F.2d 747, 757.)

◦ Otherwise, the "horizontal exhaustion" rule applies and all applicable primary policies must exhaust before an excess carrier is required to "drop down" and provide coverage. (*See, e.g., Cmty. Redevelopment Agency v. Aetna Cas. & Sur. Co.* (1996) 50 Cal.App.4th 329, 341; *Olympic Ins. Co. v. Employers Surplus Lines Ins. Co*. (1981) 126 Cal.App.3d 593, 600.)

◦ In situations involving progressive injury claims spanning multiple policy periods, the priority of coverage analysis can become very complex when there are both: (1) "specific" and "general" excess policies in the mix; and (2) there are multiple layers of excess coverage. California's general priority of coverage rules appear to require: (1) that "specific" excess policies go before "general" excess policies at the same level once the scheduled primary coverage under the "specific" excess policy exhausts, notwithstanding the presence of other excess coverage; and otherwise (2) all "general" excess policies at a lower level of coverage (first layer excess) must horizontally exhaust before the next higher level of "general" excess coverage (second layer excess) would apply. The issue regarding the scope and application of the "horizontal exhaustion" rule in the context

of multiple excess layers and progressive injuries is currently before the California Supreme Court in *Montrose Chem. Corp. of California v. Superior Court* (2017) 14 Cal.App.5th 1306, *review granted Montrose Chem. Corp. of California v. S.C.* (Cal. 2017) 406 P.3d 327.

III. ISSUES AND STRATEGIES FOR INVOLVING/DEALING WITH MULTIPLE CARRIERS IN THE CONTEXT OF CIVIL LITIGATION

A. Issues Re: Notice

- With respect to primary carriers, it is always advisable to provide notice of claims/lawsuits at the earliest opportunity since a primary carrier's defense duty is not triggered until it receives notice of the claim or suit. (*Montrose Chem. Corp. v. Superior Court* (1993) 6 Cal.4th 287, 295.)
- Also, liability carriers can often avoid any obligation to pay for pre-tender defense costs based on standardized "no voluntary payments" policy language. (*See Insua v. Scottsdale Ins. Co.* (2002) 104 Cal.App.4th 737, 743; *Gribaldo, Jacobs, Jones & Assocs. v. Agrippina Versicherunges A*. (1970) 3 Cal.3d 434, 449.) However, an insured may still be able to recover pre-tender defense costs by showing they were not "voluntarily" incurred (i.e. the insured had to act immediately to protect itself before it could tender the suit, it was not previously aware of available insurance policies, etc.) (*See, e.g., Low v. Golden Eagle Ins. Co*. (2003) 110 Cal.App.4th 1532, 1545; *Fiorito v. Superior Court* (1990) 226 Cal.App.3d 433, 440.)
- Also, early in the litigation it is advisable to determine what additional coverage may be available from other contractual indemnitors and their insurers (i.e. under additional insured endorsements) and to make tenders based on those coverages. If the coverage from the contractual indemnitors and/or their carriers is fault-based, it

may be advisable/necessary to file a cross-complaint against the contractual indemnitor to support the demand for a defense/indemnity.

- It may be also advisable to put any umbrella carriers on notice if the umbrella policy would act to "fill gaps" in coverage provided by the primary policy. In addition to potentially making more primary limits available for settlement purposes, having multiple carriers sharing defense costs could make them more amenable to paying more for the defense (i.e. higher counsel rates) since the costs are shared among multiple carriers.
- While it is not always necessary to put excess carriers on notice of every claim, it is advisable as soon as it appears there is a reasonable chance that the settlement could impact the excess layer. Not only will earlier notice help avoid notice disputes with the excess carrier, involving the excess carrier earlier in defense communications may help to persuade the excess carrier that a settlement invading the excess layer is necessary/unavoidable.

B. <u>Communication Issues During The Course Of The Defense</u>

- Communication issues can arise in connection with suits where the exposure potentially involves multiple layers of coverage. First, as noted above, including excess carriers in defense communications when the liability exposure will potentially impact the excess layer can help avoid subsequent disputes that the excess carrier was not sufficiently informed as required for it to meaningfully participate in settlement communications.
- Also, if there is a potential for settlements which will exhaust the primary limit thereby requiring the excess carrier to "drop down" and defend remaining claims, it is

advisable to communicate the likelihood of such exhaustion to the excess carrier as soon as possible to avoid primary/excess carrier disputes which could affect the defense.

- At the same time, several potential issues arise regarding the privileges which attach to communications between primary and excess carriers:
    - Some federal courts have held that defense and settlement discussions between defense counsel and the primary and excess carriers may be within the scope of the attorney client privilege under the "common interest" doctrine since such communications are necessary and in furtherance of the insured's defense. (*See Walters Wholesale Elec. Co. v. National Union Fire Ins. Co. of Pittsburgh, PA* (C.D.Cal. 2008) 247 F.R.D. 593, 597.)
    - However, communication with a non-defending carrier which are normal business communications (i.e. keeping the non-defending carrier apprised of the suit) and which are not part of joint defense efforts may not be privileged since there is no reasonable expectation of privacy with respect to those communications.
        - Example: Insured corporate directors entered into joint defense and confidentiality agreement in shareholder derivative action. Insureds sent communications to primary D&O carrier, which subsequently entered into a confidentiality agreement with the insureds. Since the D&O carrier was not providing a defense and the insureds' communications were designed to provide the D&O carrier with information regarding the status of the case, the

attorney client and work product privileges did not apply. (*In re Imperial Corp. of Am*. (S.D.Cal. 1995) 167 F.R.D. 447, 455, *aff'd*, 92 F.3d 1503 (9th Cir. 1996).) Moreover, the fact that the D&O carrier has entered into a confidentiality agreement did not change the result because the communications were not part of the defense, they were normal business communications designed to encourage the D&O carrier to participate in settlement and the D&O carrier had not committed to providing coverage, indicating it was potentially adverse to insureds when communications were made. (*Id.*, 456-457.)

- Similarly, communications between an insured and/or defending liability carrier with a non-defending excess carrier may not be privileged when their interests are potentially adverse to each other (i.e. coverage disputes have arisen).
  - Example: Insured sued for wrongful death action had two primary policies, only one of which had an immediate defense duty because the other policy was subject to an SIR. Defending primary carrier had conflict of interest and defended via independent counsel. Defending primary carrier settled case and sought contribution for settlement payments from non-defending carrier. Communications between insured's defense counsel to non-defending carrier (designed to satisfy notice requirements in non-defending carrier's policy) were not privileged and subject to

discovery by defending carrier since defense counsel did not represent the non-defending carrier in "tripartite relationship." (*See Cont'l Cas. Co. v. St. Paul Surplus Lines Ins. Co.* (E.D. Cal. 2010) 265 F.R.D. 510, 523-524.) Moreover, fact that non-defending carrier did not dispute coverage did not change result since non-defending carrier had coverage defenses against defending carrier which were based on the actions of the insured. (*Id.*, 525.)

- (Sort of) Hypothetical: Primary carrier is attempting to resolve pending, pre-suit third party property damage claims against insured by making multiple, partial repair payments without obtaining a formal settlement. When repair estimates indicate costs likely will exceed primary limit, excess carrier is put on notice by insured and primary carrier, both of whom urge excess carrier to assume defense and settle case. Excess carrier files declaratory relief action against primary carrier contending: (1) repair payments absent settlement do not exhaust the primary indemnity layer; and (2) primary carrier and insured are "colluding" to artificially exhaust the primary layer. In declaratory relief action, excess carrier seeks via discovery written communications between primary carrier's coverage counsel and insured's broker regarding the insured's settlement strategy (i.e. attempts to exhaust the primary layer). Primary carrier objects based on attorney client/work product privileges, asserting the

"common interest" doctrine. Trial court result: Non-mediation protected documents subject to discovery since primary carrier's coverage counsel was not defending insured and communications regarding excess carrier's coverage obligations were not shown to be in furtherance of the insured's defense against the pending property damage claims.

C. Issues Re: Settlement Affecting Multiple Layers Of Coverage

- Early communication of issues involving the insured's liability exposure should be made to the excess carrier to increase the chances that the excess carrier will meaningfully participate in settlement discussions.
- Also, under the *Diamond Heights* rule, communications with the excess carrier are necessary if the primary carrier wishes to agree to a settlement which invades the excess layer. (*See Diamond Heights, supra,* 227 Cal.App.3d 563, 577.)
- If there are outstanding priority of coverage disputes between carriers at the time of settlement, it is likely that the carriers will want to put terms in the settlement to preserve their respective rights to seek contribution/indemnity from each other.

D. Potential Issues Post-Settlement/Trial

1. Coverage Litigation

- Because priority of coverage disputes often arise in the context of litigation involving multiple liability carriers, it is common to have subsequent, separate coverage litigation between the carriers to resolve such disputes, particularly if the disputes could significantly shift costs of defense and/or settlement between the carriers.
- Subsequent priority of coverage suits between carriers based on their respective policy language often do not involve the insured(s) since the outcome is based on

contractual interpretation issues. However, if the priority of coverage dispute may turn on the application of a contractual indemnity provision, the carrier(s) may bring the insured part(ies) into the coverage litigation to resolve issues involving the application of the contractual indemnity provision. (*See, e.g., Reliance Nat. Indem. Co. v. Gen. Star Indem. Co*. (2002) 72 Cal.App.4th 1063, 1082; *JPI West Coast Constr., L.P. v. RJS & Assoc., Inc.* (2007) 156 Cal.App.4th 1448, 1463-1465.)

- ◦ Note: The insured(s) often have no desire to be involved in such subsequent litigation since the corresponding liabilities (i.e. contractual indemnity) are normally covered by their liability insurer. At the same time, since their contractual indemnity obligations typically fall within the scope of liability coverage, the insured can tender these same claims to their own carrier for a defense. Moreover, to avoid additional defense cost exposure caused by subsequent coverage litigation, it may be possible to persuade the carriers in the dispute to enter into an agreement that they can litigate any contractual indemnity disputes between themselves without having the original contractual indemnitees in the litigation – thereby allowing the insured contractual indemnitees to be dismissed.

2. Buss/Blue Ridge Demands

- Under *Buss v. Superior Court* (1997) 16 Cal.4th 35, in a "mixed claim" situation where there are both covered and non-covered claims pending against an insured, a defending carrier can: (1) initially provide a defense against all claims under a reservation of rights; and (2) at the conclusion of the action, seek reimbursement for defense costs solely attributable to non-covered claims. (*Id.*, 49-50.)

- Similarly, under *Blue Ridge Ins. Co. v. Jacobsen* (2001) 25 Cal.4th 489, an insurer who adequately reserves rights can settle an action against the insured and subsequently seek reimbursement for amounts paid in settlement for non-covered claims. (*Id.*, 504-505.)
- In the event of a *Buss/Blue Ridge* situation where the insured also has excess/umbrella coverage which is broader than the primary coverage, the defending carrier would also have the option of seeking reimbursement from the excess/umbrella carrier for defense/settlement costs solely associated with non-covered claims via equitable subrogation (i.e. the primary insurer paid an obligation of the insured which is owed by the excess/umbrella carrier).
- An additional complication could arise if the primary policy is a "burning limits" policy (i.e. costs of defense erode the applicable indemnity limit). An excess carrier may complain that a primary carrier's failure to pursue *Buss* reimbursement prematurely exhausted the primary coverage limit, thereby prematurely triggering excess coverage. However, it does not appear likely that this theory would be successful in California given that: (1) there are no reciprocal duties between primary and excess carriers since they do not have contracts with each other; (2) there appears to be no basis for a duty by the insured towards the excess carrier to avoid prematurely exhausting the primary layer through defense costs; (3) the language of a "burning limits" policy expressly allows exhaustion of the indemnity limit by defense costs, distinguishing this situation from "tender the limits" cases which did not exhaust coverage under the terms of the primary policy; and (4) the courts would likely favor the insured's interest in avoiding *Buss* reimbursement over the excess

carrier's interest in avoiding defense costs which it contractually promised to provide upon exhaustion of the primary limits.

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