wiley

NEWSLETTER

Excess Policy Triggered by Exhaustion of Primary Policy Even Though Insured Paid Deductible to Primary Insurer

April 2012

The United States District Court for the Southern District of California has found that an excess errors and omissions insurer was required to defend an underlying claim because the primary policy was exhausted by the primary insurer's payment of its full limit of liability, even though the policyholder paid the deductible amount to the primary insurer and not for settlement or defense expenses. *Liberty Mut. Ins. Co. v. Indian Harbor Ins. Co.*, 2012 WL 642890 (S.D. Cal. Feb. 28, 2012). The court found further that, because the excess policy was specifically excess of the relevant primary policy, the excess insurer was required to defend without requiring exhaustion of a potentially applicable run-off policy.

The underlying claimant sued the insured, a third-party claims administrator, alleging negligence in claims handling during a period covered by both primary and excess E&O policies and previously issued run-off policies. The issuer of the primary policy had contributed its full $5 million limit of liability toward settlement of the personal injury claim from which the allegedly negligent claims handling arose. The insured had not, however, paid the $75,000 deductible under the primary policy until after the personal injury settlement. At that time, the insured paid the amount of the deductible to the primary insurer. Accordingly, the excess insurer contended that it was not obligated to defend the negligence action because the primary policy was not exhausted. Moreover, the excess insurer argued that its policy was not triggered until both the primary policy and the primary run-off policy were exhausted because both potentially afforded coverage for the pending claim.

The court disagreed with the excess insurer. The primary policy provided that the primary insurer was "not obligated to pay any damages or claims after the applicable limit of liability has been exhausted by the payment of damages or claim expenses." The court determined that "whether [the insured] paid its $75,000 deductible is not indicative of whether the [primary] policy was properly exhausted." Because the primary insurer paid its full limit in settlement of the earlier claim, the court found that it was exhausted.

With respect to exhaustion of the run-off policy, the court determined that "horizontal exhaustion" of both the primary policy and the primary run-off policy was not required. "Vertical exhaustion" applies, the court found "if, and only if, the excess policy provides that it is excess to a *specified* primary policy. This is true even when the primary policies apply to different policy periods." The excess policy provided that it was specifically excess of the primary policy, which the court had found to be exhausted. Accordingly, vertical exhaustion applied, and the excess policy was triggered.