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CLIENT ALERT

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Ninth Circuit Sharply Curtails Excess Insurers' Ability to Challenge Propriety of Primary's Exhaustion in *AXIS Reinsurance Co. v. Northrop Grumman Corp.*

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When a company is faced with defending itself against a large claim, it often requires the availability of insurance proceeds from not just the company's primary insurer, but also from its excess insurance layers. In this scenario, however, excess insurers sometimes will refuse to step in after exhaustion of the underlying insurance layers, arguing that the exhaustion of those underlying layers was wrongful due to payments for uncovered claims. The excess insurer's argument that its policy has not been triggered threatens to leave the insured exposed for such amounts.

The Ninth Circuit Court of Appeal addressed this issue on September 14, 2020, in *AXIS Reinsurance Co. v. Northrop Grumman Corporation*, No. 19-55135, 2020 WL 5509743 (9th Cir. Sept. 14, 2020), and severely limited an excess insurer's ability to second-guess underlying insurers' payment decisions. The Court reversed the lower court's decision, which had held that AXIS had overpaid Northrop's settlement of a class action lawsuit, and thereby was entitled to reimbursement from Northrop, because Northrop's underlying insurers "improperly exhausted" their policies.

The Ninth Circuit panel rejected AXIS's argument, which it referred to as the "improper erosion" theory of recovery, that when an insured purchases multiple layers of insurance, the insured bears the risk that an excess insurer may disagree with the underlying insurer's payment decisions and withhold payment of otherwise valid claims due to allegedly improper payments for uncovered loss. The panel noted that AXIS's argument, if accepted, "'would undermine the confidence of both insureds and insurers in the dependability of settlements,' eliminating one of the primary incentives for obtaining insurance in the first place."

Instead, the Court adopted Northrop's position – that an excess insurer (AXIS), not the insured (Northrop), must assume the risk that underlying insurers might adjust claims in a way that exhausts underlying limits and thus trigger that excess insurer's coverage. The panel adopted a "general rule" that an excess insurer cannot challenge underlying insurers' payment decisions to argue that its own coverage layer has not been reached.

This "general rule" adopted by the Ninth Circuit was established previously in

Costco Wholesale Corp. v. Arrowood Indem. Co., 387 F. Supp. 3d 1165 (W.D. Wash. 2019), a federal district court case out of Washington. In *Costco*, a third layer excess insurer argued that "its policy should never have been triggered because the underlying insurers should have refused to pay some or all of the invoices submitted to them in relation to an $8 million class action settlement between Costco and its employees with over $30 million in defense fees." The insurer in that case argued that "each excess insurer in an insurance tower can force the insured to prove that every payment made by the underlying insurers fit the definition of 'Loss.'" The *Costco* court rejected this argument observing that an excess insurer generally "may not . . . second-guess the coverage determinations of the underlying insurers" absent a "contractual right to interfere in their adjustment processes."

The Ninth Circuit panel, however, did note two exceptions to this "general rule" of no second guessing by excess insurers. These two exceptions are (1) when an excess insurer includes specific language in its policy "reserving its right to contest 'improper erosion' by the underlying insurers under certain conditions," – so long as such a provision is not forbidden by law or public policy of the state in which the insurer is operating; and (2) if an excess insurer can show that a lower-level insurer's decision to cover a claim was motivated by fraud or bad faith.

<u>Why it matters</u>: The *AXIS* decision protects insureds from being left holding the bag if an excess insurer objects and refuses to acknowledge that its policy has been triggered once underlying insurance has paid its limits. This provides great protection to an insured that it will not be faced with the exhaustion of lower level insurance only to get met with an excess insurer's refusal to then step in, based upon an argument that the underlying insurer's exhaustion of its limits were somehow improper.

Moreover, while the panel did note two exceptions, these exceptions likely will not often come into play. Historically, standard excess policies have not included explicit terms that reserve the right to contest "improper erosion" by the underlying insurers. (Insureds should think twice about purchasing an excess policy containing such a provision in the future.) Also, it would be difficult for an excess insurer to prove that one or more of the underlying insurers exhausted their policies fraudulently or in bad faith. To be sure, it difficult for an excess insurer to prove what incentive the underlying insurer(s) had to improperly exhaust the underlying insurance.

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