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Alert

New Decision Requiring Exhaustion of Underlying Insurance – Quellos Group LLC., v. Federal Insurance Company

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On November 12, 2013, the Court of Appeals of the State of Washington, became the latest appellate court to find that excess insurance policy language that required actual payment of underlying insurance limits be followed in a less than policy limits settlement.

In this action, the State's intermediate appellate court affirmed the dismissal of a lawsuit by an insured against excess insurers, finding that the underlying policy had not properly been exhausted by a less than limits settlement by the primary insurer. As part of its decision the Court rejected an attempt by the insured to "bridge the gap" by self-funding the unpaid underlying limit.

In Quellos Group LLC. v. Federal Insurance Company, et al., Docket No. 68478-7-1, the Court of Appeals, applying Washington State law, interpreted two excess insurance policy provisions to determine that the plain and unambiguous language required "exhaustion of the underlying liability limits by actual payment by the insurer before excess coverage is triggered." The Court held that because the "underlying insurers did not pay policy limits," the dismissal of the coverage action against the excess insurers should be affirmed.

The underlying facts relate to a tax shelter strategy developed by the insured, Quellos Group LLC ("Quellos"), an investment management firm, which utilized offshore shell corporations to provide the illusion of "fake" capital losses to offset large capital gains obtained by clients. Quellos provided false documentation to law firms in order to obtain favorable legal opinions that supported the program in order to gain clients. The IRS subsequently audited Quellos and denied the tax benefits obtained by Quellos's clients. A number of clients threatened legal action and Quellos reached multi-million dollar settlements with these clients. In December, 2009, the United States Attorney indicted Quellos Directors, Greenstein and Wilk for tax evasion and conspiracy to defraud the IRS. Greenstein and Wilk subsequently pled guilty to the charges.

Quellos had purchased a claims-made investment management primary policy issued by AISLIC with a $10 million limit, subject to a $2.5 self-insured retention, for the period at issue. Quellos obtained

excess insurance for this period from Federal Insurance Company ("Federal") and Indian Harbor Insurance Company ("Indian Harbor"). The first tier Federal policy provided $10 million of limits and the second tier Indian Harbor policy provided excess coverage of $20 million after exhaustion of AISLIC and Federal limits. The Federal policy states 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**." The Indian Harbor policy states coverage "**will attach only after all of the Underlying Insurance has been exhausted by the actual payment of loss by the applicable insurers thereunder**." Quellos sought coverage from the insurers for approximately $35 million in settlements with individual investors and approximately $45 million in defense costs incurred in the Federal investigation and enforcement action.

AISLIC determined that Quellos was entitled to $4,982,974 of the $10 million policy limit underlying the Federal and Indian Harbor policies and the dispute with the Primary was resolved on that basis. In an attempt to trigger the excess coverage, Quellos agreed to pay the gap between the $10 million primary limit and the approximately $5 Million paid by AISLIC. Quellos filed a declaratory judgment action against the two excess insurers to compel coverage. Federal and Indian Harbor moved for summary judgment partly on the grounds that the failure to exhaust the primary coverage was an absolute bar to the excess coverage. The trial court held that the exhaustion language in the excess policies was unambiguous and was a "defining characteristic of an excess insurance policy" and therefore, Quellos's claims were barred.

On appeal, the Court of Appeals agreed with the trial court that the "plain and unambiguous language [of the excess policies] compels the conclusion that the excess coverage was not triggered by the decision of Quellos to self-fund the remaining policy limits of approximately $5 million that AISLIC refused to pay." The Court looked to specific language in both polices which required payment "in legal currency" and "actual payment" before the excess policies would be triggered. The Court determined that the intent of the parties was that the excess insurance would only be triggered after actual payment of the underlying limits and that the Indian Harbor policy had an available amendment which would have allowed the insured to pay the full amounts of the underlying coverage to trigger excess coverage, which was not in this policy.

The Court distinguished Zeig v. Massachusetts Bonding & Insurance Co., 23 F.2d 665 (2d Cir. 1928) which was relied upon by Quellos, stating that in Zeig and related cases, "there was either an ambiguity in the definition of "exhaustion" or a lack of specificity in the policy language as to how to exhaust primary insurance." The Court concluded that here, similar to the holding in Qualcomm, Inc. v. Certain Underwrites at Lloyd's, London, 73 Cal Rptr 3d 770 (Cal. Ct. App. 4 2008), the plain and unambiguous language of the excess insurance policies unambiguously states how the underlying insurance is exhausted. Accordingly, the Court held that the language of the Federal and Indian Harbor polices should be enforced as written and summary judgment as to the lack of coverage due to exhaustion was affirmed.

This decision continues a series of rulings across the country which have rejected the rationale of Zeig

(where the Second Circuit Court of Appeals upheld exhaustion by a less than policy limits settlement on public policy grounds), in favor of the analysis of more recent cases such as Qualcomm, Inc. v. Certain Underwriters at Lloyd's, London, 161 Cal. App. 4th 184 (Cal. App. 4th Dist. 2008) (holding that clear policy language requiring exhaustion by actual payment of underlying limits will be enforced); Intel Corp. v. American Guarantee & Liability Insurance Co., 2012 Del. LEXIS 480, Case No. 692, 2011 (September 7, 2012) (where the Delaware Supreme Court held that Intel's settlement with AGLI's underlying insurer for less than policy limits did not constitute exhaustion). We believe this decision is especially helpful given that Washington State is generally regarded as an unfriendly jurisdiction for insurers. A copy of the decision is attached.

Should you have any questions about this decision, or any other matter, please do not hesitate to contact us.