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## **RENEWAL STRATEGIES FOR POLICYHOLDERS: MODERATING THE IMPACT OF THE CURRENT ECONOMIC CRISIS**

*by Richard Shore and Jonathan Terrell*

*This is the first part of a two-part series outlining strategies policyholders can pursue to manage their insurance assets effectively in the current economic downturn. This installment focuses on strategies related to the placement of new or renewal coverage. The second installment will address strategies for dealing with existing coverage and coverage claims in turbulent economic times.*

The nationwide economic crisis is having a widespread impact on financial firms of all types, and insurers are not immune. Their investments have lost value, their investment income has decreased, they are facing possible decreases in premium income due to the weak economy, and claims – particularly under directors & officers, errors & omissions, crime, and employment practices liability policies – have increased or are expected to do so. Although there are reasons to believe that the financial effects of the economic crisis will be less serious for insurers than for many other financial firms – among other things, insurers pursue conservative investment strategies and are not highly leveraged – policyholders are understandably concerned about the creditworthiness of their insurers. In the current environment, it is reasonable to assume that insurer insolvencies, which have been at a relatively low level for the past several years, will at the very least return to normal levels in 2009 and beyond. There are a number of strategies policyholders can employ to moderate the impact of increasing insurer insolvencies.

**First**, in placing or renewing coverage, policyholders should go beyond credit-agency ratings in assessing the creditworthiness of insurers in their proposed coverage programs. A strong credit rating provides less comfort than one might believe. Ratings agencies do not bring the expected independence, and they are often surprised by

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adverse developments. In several cases, insurers in run-off or liquidation had healthy ratings shortly before they ceased underwriting. For example, Royal Insurance Company, which went into run-off in 2003, had an A+ rating in 2001; and Reliance Insurance Company, which went into run-off in 2001, had an A- rating in 2000. Eric Dinallo, who recently resigned as New York's insurance commissioner, described the insurance ratings system as "fundamentally flawed" and the ratings as inflated in an opinion piece in the Wall Street Journal in March. The National Association of Insurance Commissioners is examining whether regulators have been overly dependent on insurance ratings agencies.

Policyholders can better assess insurer creditworthiness by reviewing broker analyses and insurer annual reports, listening to analyst briefings, and undertaking their own financial analyses. Red flags include concentrated ownership, a non-insurance holding company (although there are prominent exceptions), recent entrance into new lines of underwriting, and high-risk profiles in affiliates.

**Second**, in renewing or replacing coverage, policyholders should carefully examine provisions regarding the exhaustion of underlying limits of liability and should reject language that insurers successfully have argued in a number of recent cases allow them to avoid their coverage obligations. Policyholders reasonably assume that excess insurers are obligated to pay if and when the policyholder's liability exceeds any applicable liability limits of the underlying primary and excess coverage. Courts across the country have so ruled in cases stretching back more than 80 years. Beginning with the seminal Second Circuit decision in *Zeig v. Massachusetts Bonding & Insurance Co.* in 1928, numerous courts have held that a settlement between a policyholder and an insurer for less than any applicable limit of liability does not result in a forfeiture of overlying excess coverage, as long as the policyholder's liability exceeds the applicable underlying coverage limits.<sup>1</sup>

But in a number of recent intermediate appellate court cases, including *Comerica Inc. v. Zurich America Insurance Co.*<sup>2</sup> in 2007 and *Qualcomm, Inc. v. Certain Underwriters At Lloyd's, London*<sup>3</sup> in 2008, insurers successfully have argued that certain language in some excess policies negates coverage if underlying insurers do not pay the full amount of applicable underlying liability limits, even if the policyholder's total liability

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<sup>1</sup> See *Zeig v. Mass. Bonding & Ins. Co.*, 23 F.2d 665 (2d Cir. 1928); see also *Pereira v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, No. 04 Civ. 1134 (LTS), 2006 WL 1982789, at \*7 (S.D.N.Y. July 12, 2006); *Elliott Co. v. Liberty Mut. Ins. Co.*, 434 F. Supp. 2d 483, 499-500 (N.D. Ohio 2006); *St. Paul Surplus Lines Ins. Co. v. Life Fitness*, No. C3-99-9980, 2001 WL 588949, at \*3-4 (D. Minn. Jan. 29, 2001); *Kelley Co., Inc. v. Cent. Nat'l Ins. Co. of Omaha*, 662 F. Supp. 1284, 1288-90 (E.D. Wis. 1987); *Siligato v. Welch*, 607 F. Supp. 743, 746-47 (D. Conn. 1985); *Home Indem. Co. v. Mission Ins. Co.*, 251 Cal. App. 2d 942, 965-66, 60 Cal. Rptr. 544, 561-62 (Cal. Ct. App. 1967); *HLTH Corp. v. Agric. Excess & Surplus Ins. Co.*, C.A. No. 07C-09-102 RRC, 2008 WL 3413327 (Del. Super. July 31, 2008); *Reliance Ins. Co. v. Transamerica Ins. Co.*, 826 So. 2d 998, 999-1001 (Fla. Dist. Ct. App. 2001); *Futch v. Fid. & Cas. Co. of N.Y.*, 166 So. 2d 274, 278 (La. 1964); *Weaver v. Kitchens*, 570 So. 2d 508, 510 (La. Ct. App. 1990); *Drake v. Ryan*, 514 N.W.2d 785, 789-90 (Minn. 1994); *Rummel v. Lexington Ins. Co.*, 945 P.2d 970, 977-79 (N.M. 1997); *Teigen v. Jelco of Wis., Inc.*, 367 N.W.2d 806, 810 (Wis. 1985)).

<sup>2</sup> *Comerica Inc. v. Zurich Am. Ins. Co.*, 498 F. Supp. 2d 1019 (E.D. Mich. 2007).

<sup>3</sup> *Qualcomm, Inc. v. Certain Underwriters At Lloyds, London*, 161 Cal. App. 4th 184, 73 Cal. Rptr. 3d 770 (Cal. Ct. App. 2008).

exceeds the underlying limits. Where the policyholder settles with underlying insurers for less than applicable limits, absorbs the shortfall itself, and then turns to overlying excess insurers for coverage of amounts exceeding the underlying limits, excess insurers argue that they owe nothing. Insurers assert that the same result applies where an underlying insurer fails to pay full limits for any other reason, including insolvency or other financial impairment – situations that may become more common given the current economic downturn.

The *Comerica* and *Qualcomm* holdings have been widely criticized, and for good reason. They flout long established precedent, ignore relevant policy language, defeat policyholders' reasonable expectations of coverage, contravene important public policies, including those favoring settlement, and confer an unjustified windfall on excess insurers. Ironically, by discouraging compromise, the holdings may result in insurers being compelled to litigate cases they would rather settle, thus undercutting their broader interests.

Although there is more than ample reason to disagree with the recent cases, policyholders should reject language in any new or renewal policies like that found in *Comerica* and *Qualcomm* to result in a forfeiture of excess coverage based on below-limits settlements with underlying insurers.<sup>4</sup>

**Third**, although policyholders purchasing new or renewal coverage should consider new insurance products that may mitigate the effect of insurer insolvencies, policyholders should maintain a healthy skepticism and keep in mind that such products are far from a panacea.

For example, at least one insurer is offering an endorsement to some of its policies that gives the policyholder the right to receive a *pro rata* (that is, proportionate) return of premium, with no minimum earned premium, in the event that the insurer's financial rating is downgraded below a designated level. Policies typically provide that when a policyholder cancels, the policyholder's premium refund is calculated on a "short rate" basis and is less than a proportionate premium refund. For example, if the policyholder cancels on day 182 of a one-year policy period – that is, approximately halfway through – the premium refund calculated on a short-rate basis may be only forty percent (40%) of the full annual premium. In addition, policies may be subject to a minimum earned premium – potentially 25% or more of the full annual premium – regardless when a policyholder cancels, which can be a significant financial penalty.

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<sup>4</sup>Policyholders with coverage claims implicating existing policies should carefully review all potentially applicable excess policies to determine whether they contain such language and factor that into the decision whether and under what circumstances to settle with underlying insurers. If the language is present, settling with underlying insurers may be problematic, unless the jurisdiction whose law applies clearly has rejected the holdings of *Comerica* and *Qualcomm*, the settlements are made contingent on the policyholder's also reaching acceptable settlements with excess insurers whose policies include the problematic language, or the policyholder takes other steps to avoid the arguments of excess insurers seeking forfeiture windfalls.

Although the ratings downgrade endorsement has some value, even a *pro rata* return of premium does not adequately compensate the policyholder for the value of coverage lost due to a ratings downgrade or a policy cancellation resulting from such a downgrade. That is because a policy's coverage is not limited to the policy period, and the policyholder may be entitled to payment from the insurer long after the end of the policy period. Occurrence-based coverage continues indefinitely after the policy period for occurrences that result during the policy period in bodily injury or property damage. Claims-made policies provide coverage after the policy period for, among other things, claims made after the policy period that result from circumstances as to which notice is given during the policy period, and for claims as to which there is an extended reporting period. And to the extent that a ratings downgrade reflects an impaired ability to pay claims over time, the right to receive some or even all of the premium back is small compensation to a policyholder facing significant defense costs or losses that the downgraded insurer might fail to pay as promised.

Another example of a new insurance product designed to respond to policyholder concerns about increasing insurer insolvencies is a program that allows policyholders to pay an up-front non-refundable fee to lock in replacement coverage from a competing insurer in the event that an insurer that issued a policy in the policyholder's current coverage program becomes insolvent or otherwise financially impaired. As with the ratings downgrade endorsement discussed above, the option to bind the replacement coverage generally applies only during the policy period, and thus it provides limited protection for insolvency risk, and none for periods of active coverage after the end of the policy period. While such a program may be beneficial if the cost is modest, given the limitations it may not be justified if the cost is significant. Moreover, as discussed above, policyholders can minimize the credit risk in their insurance portfolio during the limited time horizon that would be covered by such a program by carefully assessing the creditworthiness of their insurers before binding coverage.

A third insurance product is upper-layer D&O coverage that promises to "drop down" in the event that a lower level insurer becomes insolvent or financially impaired, or otherwise fails to make timely payment of claims. As with the replacement product discussed above, whether such a product is worthwhile will depend in significant measure on the cost.

**Fourth**, policyholders should limit the amount of cash collateral they are required to deposit with insurers at any one time under workers' compensation and other coverage programs with large deductibles or retrospective premium obligations. In the event an insurer enters rehabilitation or insolvency, the rehabilitator or liquidator may take the position that such collateral is property of the insurer's estate, available to satisfy the claims of all creditors of the state. This issue became something of a *cause célèbre* in the Reliance Insurance Company liquidation proceedings in Pennsylvania.

During the Reliance liquidation proceedings, a dispute arose between Reliance policyholders and the Reliance Liquidator over the correct disposition of collateral deposits. The Reliance Liquidator argued that collateral

securing the deductible liability was an asset of the estate to be used for the benefit of all policyholder claimants. Policyholders argued that the collateral should be available to pay any covered claims falling within the deductible applicable to the policyholder in question.

Pennsylvania and Illinois subsequently enacted legislation providing that collateral held by an insurer (or its receiver) to secure the obligations of a policyholder to pay deductibles is not considered an asset of the insurer's estate in the event of rehabilitation or liquidation.<sup>5</sup> The New York Insurance Department issued an opinion at the end of 2008 stating that "where there is a bona fide agreement between a policyholder and an insurer that specifically characterizes an asset as collateral and not part of the general assets of the insurer, such collateral will not be included in the general assets of the insurer's estate in liquidation or rehabilitation."<sup>6</sup> The Opinion Letter relied in part on a provision of New York's insurance statute excluding property "pledged, deposited or otherwise encumbered for the security or benefit of specified persons or a limited class of persons" from the general assets of an insurer in liquidation.<sup>7</sup> Collateral deposited with an insurer to cover workers' compensation deductibles would fall within this carve-out. To the extent that statutes or opinions of state insurance regulators provide a safe harbor for collateral, policyholders should check that their policies or other relevant agreements carefully track the relevant requirements and language of the applicable statutes or opinions.

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The current economic crisis is causing policyholders to look even more carefully than usual at their coverage programs at renewal time. The foregoing strategies are among those that policyholders can employ to mitigate the risks of anticipated increases in insurer insolvencies. These strategies should be part of an overall campaign to strengthen coverage portfolios and thus gain additional value from insurance assets in these difficult economic times.

*The opinions expressed in this advisory reflect the personal opinions of the authors and do not necessarily constitute positions of their firms or any of their clients.*

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<sup>5</sup> Pennsylvania Insurance Law Section 40-11-405.1; Illinois Statute, 215 ILCS Section 5/25.1.

<sup>6</sup> Op. Ltr., Office of General Counsel, New York Insurance Department (Dec. 31, 2008).

<sup>7</sup> N.Y. Ins. Law § 7408(b)(7).