Drop Down? Drop Dead!
Excess Insurers Not Required to Provide Primary Coverage in Lieu of an Insolvent Insurer

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Courts have consistently ruled that excess insurers are not required to provide “drop-down” coverage to pay for losses sustained by policyholders in cases where (a) the primary underlying insurer is insolvent and unable to pay or (b) the policyholder itself is in bankruptcy and is unable or unwilling to pay the deductible or self-insured retention amount. Why do so many insured parties seem to have missed the message and still seek to have their excess carriers provide drop-down coverage? This article will examine the issue by looking at several recent cases.

Excess insurance has several forms, but the purpose is the same. Companies may purchase direct primary insurance that has a “retained limit” or threshold loss amount that must be reached by the policyholder before the excess insurance coverage comes into effect. Conversely, companies will either pay a deductible or agree to a “self-insured retention” (SIR) up to a specific amount of loss. Under a typical excess insurance contract, the excess-policy carrier will only be liable for coverage once the retention limit (the threshold amount) has been reached. In a hypothetical case, the insured entity may have a SIR of $300,000 per covered event, after which the excess carrier will provide coverage up to a maximum amount, if any, set forth in the policy. With larger entities and greater risk, there are often multiple carriers and overlapping contracts for primary and excess coverage. In such cases, an excess insurance carrier

1 This article does not deal with workers’ compensation coverage, for which excess insurers are generally required to provide drop-down coverage in the event of insolvency by the primary carrier.

may be second or third in line behind primary and other insurers. Figuring out who is responsible for coverage—and for how much—can keep many lawyers busy, depending on the complexity of the situation and the size of the loss.

What happens when a primary insurer (or another excess carrier) is insolvent and unable to meet the retention limit? The default position is that the contract between the parties governs. A recent example is the case of Premcor USA Inc. v. American Home Assurance Co., 2004 WL 1152847 (N.D. Ill. May 21, 2004), aff'd, 400 F.3d 523 (7th Cir. 2005). In that case, two Premcor employees were fatally injured on the job and their estates filed wrongful-death claims. Premcor was covered by several insurance policies. The initial layer was a $2 million general liability policy from Reliance National Indemnity Co., under which Reliance also agreed to pay unlimited defense costs for any actions covered by its policy. In addition, Premcor had an umbrella policy from American Home Assurance Co. to provide up to $10 million in excess coverage for liabilities not covered by its existing policies. One part of the AHA contract specified that it would cover losses “in excess of the amount recoverable under the underlying insurance [the $2 million Reliance policy].” However, another part of the policy stated that AHA “shall not be liable for expenses as aforesaid when such are covered by underlying policies of insurance whether collectible or not.” 400 F.3d at 525.

After Reliance became insolvent and was unable to pay its loss coverage obligations, Premcor sued AHA seeking coverage for the costs of defending the wrongful-death actions. Premcor focused on the policy language that specified AHA’s obligations “in excess of the amount recoverable” and sought to interpret the AHA policy in such a way as to make AHA a primary insurer for any gaps in its insurance coverage—based on what was “recoverable” from the primary insurer, rather than on the basis of what the various layers of insurance policies provided at the time the AHA policy was signed. The district court granted summary judgment for AHA, and on appeal, the Seventh Circuit agreed. Interpreting the contract as a whole, the appeals court ruled that the policy provided for “excess coverage only after the underlying insurance has been paid to the policy limits.” Id. at 529. The failure of the primary insurer to meet its obligations did not alter the terms of the umbrella policy, which specified that the coverage limits were irrespective of whether the underlying insurance was paid or not.

The insolvency of a self-insured policyholder is treated similarly. In In re Amatex Corp., 107 B.R. 856 (E.D. Pa. 1989), the debtor was unable to pay the $25,000 self-insured retention amount and, inter alia, moved to require the insurer, Stonewall Insurance, to pay the entire amount of its maximum limit. Since payment of the SIR constituted a post-petition breach of the pre-petition insurance contract, Stonewall would be relegated to the status of an unsecured creditor for the $25,000 self-insured retention amount. The court denied the debtor’s motion, quoting Black’s Law Dictionary for a simple definition of “self-insurance” as “setting aside a fund to meet losses instead of insuring against such through insurance.” 107 B.R. at 871. The excess insurer was not required to provide coverage until the SIR was exhausted and was not required to “drop down” and pay the SIR amount.

What if an insolvent insured refuses to expend its SIR defense costs and simply waits for the threshold amount to be reached? This is not uncommon. In Eastern Retailers Serv. Corp. v. Argonaut Ins. Co. (In re Ames Department Stores Inc.), 1995 WL 311764 at *2 (S.D.N.Y. 1995), the insured, Ames, was contractually obligated to defend and administer claims within a $50,000 deductible. When it refused to do so, its insurance carrier, Argonaut, sought to compel Ames to defend the case on the basis that if Ames did not defend the claim, a readily manageable claim within the deductible amount would readily magnify into a much-larger claim. The court denied Argonaut’s request, holding that, at most, Argonaut had an unsecured claim for post-petition breach of the pre-petition contract, and that if it wanted the claim defended, it would have to undertake the defense itself. 1995 WL 311764 at **2-3.

Similarly, the court in In re Vanderveer Estates Holding LLC, 328 B.R. 18 (Bankr. E.D.N.Y. 2005), held that the debtor’s insurer, American Safety Indemnity Co. (ASIC), could not compel the debtor to meet its pre-petition obligation to spend the first $25,000 per occurrence to defend claims as required under the insurance policy. The debtor’s payment of the deductible amount was not a pre-condition to ASIC’s performance. Any claim for nonperformance of the contract would only give rise to an unsecured claim by the insurer. 328 B.R. at 24. The policy was not an “executory contract” under §365 of the Bankruptcy Code because the premiums had been paid and the policy period had run. “The failure of the insured to perform

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in the United Kingdom. Pursuant to Article 16, the opening of collective insolvency proceedings in one member state has to be recognized by all other member states from the time it becomes effective. As a general rule, applying the principle of mutual trust, the international jurisdiction of the court that opens insolvency proceedings shall not be examined. The opinion of the court of another member state on whether the court in the first member state has correctly claimed jurisdiction is not relevant. What is relevant is whether the court in the first member state has claimed jurisdiction pursuant to Article 3(1).

Incorrectly assuming jurisdiction pursuant to the Regulation is not, prima facie, contrary to public policy. Recognition of main insolvency proceedings opened in another member state may only be refused pursuant to Article 26 if recognition or enforcement of a judgment would be clearly incompatible with public policy, and in particular incompatible with basic principles or constitutionally guaranteed rights and freedoms of the individual. If the court of another member state incorrectly claims jurisdiction or another EU law is breached, this will not be automatically contrary to public policy under Austrian law unless fundamental rules of the EU had been grossly disregarded.

The Austrian courts should only refuse to recognize insolvency proceedings opened in another member state in exceptional circumstances. It could be argued the exceptional circumstances existed because the U.K. High Court failed to give substantive reasons for its decision to open main insolvency proceedings. This is a fundamental requirement for a fair trial. However, even in these circumstances the refusal of recognition is not mandatory but optional. It could be seen from the application of the bank that the debtor had links to the United Kingdom and at least in part conducted business there. With respect to the requirements for opening insolvency proceedings, although there did not seem to be sufficient proof to counter the presumption that the debtor’s COMI is in the place of its registered office as required by Article 3(1), no violation of public policy was apparent. It might have been different had there been no internationally recognized connection at all or had additional exceptional circumstances led to an unfair trial.

Once main insolvency proceedings have been opened in a member state, only secondary insolvency proceedings can be opened in another member state. These secondary proceedings are restricted to the assets of the debtor situated in that other member state. The existence of an “establishment” is a precondition to opening secondary insolvency proceedings. In this case, it was held that there was no establishment because although assets were situated within Austria, the debtor did not have an office, employees or conduct any noticeable activities there.

This case is another in a long line of cases that U.S. lawyers will need to understand in order to make appropriate use of the new chapter 15, which came into force on Oct. 17. Specialist advice on the European experience of the new concepts of COMI and “establishment” may in appropriate cases be well worthwhile.

U.K.: Recent Case Law on Security Interests

The House of Lords (the highest court in the United Kingdom) has recently given an important judgment clarifying certain aspects of the law on granting security.6

The question that was considered by the House of Lords in Spectrum was whether a charge over present and future book debts took effect as a fixed charge (which was how it had been drafted) or as a floating charge. The charge was drafted in a form that had been approved by the court of appeal little more than 25 years earlier. The charge prevented the chargor from disposing of or charging the uncollections book debts, but allowed it to deal with its debtors and collect the debts. Proceeds of collection were to be paid into a designated account with the chargor bank, but the chargor was allowed to draw freely on the account for its business purposes, provided that the overdraft limit was not exceeded. Natwest argued that the charge created a floating charge, and the Crown creditors argued that the charge created a floating charge.

Whether a charge is a fixed or floating charge has implications for the priority of payments to the lender. Preferential creditors rank ahead of a floating chargeholder in respect of floating charge realisations, but not ahead of a fixed chargor in respect of fixed charge realisations.

The House of Lords held that the hallmark of a floating charge is that, until some further step by way of intervention is taken by the chargor, the chargor company can use the assets in question for its normal business purposes and, in using them, remove them from the security. If this characteristic is present, the charge will be a floating charge and cannot be a fixed charge, whatever its other characteristics may be. In this case, Spectrum was able to draw on the account once the book debts had been collected, and so the charge was a floating charge.

Although the charge considered in Spectrum was not a fixed charge, the court held that it was conceptually possible to take an effective fixed charge over present and future book debts, although they gave little by way of practical guidance as to how effective fixed charges over book debts should be taken forward. However, the House of Lords also made it clear that even if the charge had contained sufficient restrictions on how the money in the account could be used, if that was not how the account operated in practice then the charge would still be a floating charge.

This ruling put an end to the wait of approximately 550 corporate insolvencies that have been frozen because of the legal uncertainty arising from an earlier decision of the Privy Council in 20016 that came to the same conclusions as the House of Lords in Spectrum.

6 Agree w. Commissioners of Inland Revenue [2001] 2 AC 710.

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these continuing obligations [SIR payments] would not excuse the insurer from being required to perform...” Id at 26. In addition, because the insurance contract was a pre-petition contract and not a contract between ASIC and a debtor-in-possession (DIP), it did not qualify as an administrative claim. Id at 27.

As these recent cases show, courts take a consistent approach in consider-ing whether an excess insurer must provide “drop-down” coverage. Usually, the answer is “no.” Policyholders considering whether to sue their excess insurer should review the entire insurance policy in light of these cases. To balance the scales of justice, excess insurers cannot compel a DIP policyholder to provide coverage within its SIR or deductible amount. At best, insurers may have a pre-petition claim if the policy calls for the insured to provide defense or indemnity up to a retention amount. All this calls for careful drafting of insurance contracts providing absolutely clear expectations in the event of insolvency by a policyholder or underlying insurer. Do it right, and courts will uphold the insurance policies as written.