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Good faith duty exists from inception for excess carriers

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Excess insurers often claim their obligations under an excess policy do not arise until the underlying (i.e., primary) insurance policy has been exhausted. This, however, is not entirely accurate under California law. Excess insurance carriers owe a duty of good faith and fair dealing from the inception of the agreement. In the context of a claim that has a reasonable likelihood of triggering excess coverage, any unreasonable conduct by the excess carrier that jeopardizes the insured's claim to excess coverage can give rise to bad faith liability, regardless of whether the primary policy has been exhausted and the excess carrier's duty to pay has been triggered.

The general rule under California law is that "no benefits are due under an excess policy unless and until the underlying primary coverage is exhausted." *Schwartz v. State Farm Fire and Casualty Company*, 88 Cal. App. 4th 1329, 1335 (2001). This general rule, however, does not relieve excess insurers from the implied covenant of good faith to act fairly and not injure the insured's right to policy benefits prior to exhaustion of the underlying insurance. "[A]n excess insurer's implied covenant not to frustrate its insured's right to receive benefits of the insurance contract *exists from the inception of the agreement*." *Schwartz*, at 1336 (emphasis added). "[T]he good faith duties owed by an excess insurer include the obligation to evaluate settlement options realistically and in good faith where a claim may exceed primary policy limits." *Fuller-Austin Insulation Co. v. Highlands Ins. Co.*, 135 Cal. App. 4th 958, 987 (2006).

Schwartz illustrates an excess carrier's potential bad faith liability for unreasonable conduct prior to exhaustion of primary policy limits. The case arose in the context of competing claims to excess insurance to compensate for injuries sustained in a car accident. The question addressed was "whether the excess insurer may pay full benefits to the first insured who has exhausted the limits of the primary insurance coverage, or whether the [excess] insurer has a duty to protect the interests of the other insured who has not exhausted the primary insurance and is not yet entitled to claim excess insurance benefits."

While acknowledging that the excess insurer "had no duty to pay" policy benefits prior to exhaustion of the primary policy, *Schwartz* held that "it does not follow that [the excess insurer] had no duty to treat the [insureds] fairly." The court explained that "[t]he legal principle that a breach of the implied covenant cannot occur 'unless policy benefits are due' refers to whether the policy will eventually cover the claim, and does not depend on when such coverage finally attaches." *Schwartz* "reject[ed] the notion that, simply because a condition precedent to a particular obligation - the obligation to pay - has not yet occurred, the insurer is relieved from the implied covenants that inhere in *every* contract" (emphasis in original).

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The plaintiff in *Schwartz* argued that the excess carrier, despite knowing of the competing claims, "took no steps to reserve a proportionate share of the excess policy benefits in anticipation" of their claim. Noting that the excess carrier "was placed on notice of the [insureds'] potential interest in the benefits of their excess policy," *Schwartz* stated that "an excess insurer ... , like any other insurer, [is] obliged under the implied covenant of good faith and fair dealing to do nothing to impair the [insureds'] rights to the benefits of their agreement." *Schwartz* reversed the trial court's order granting summary judgment in favor of the excess carrier, explicitly rejecting the trial court's conclusion that excess carriers have "no duty to the [insureds] until they exhausted their primary insurance," because it was contrary to California law that the duty of good faith and fair dealing "exist[s] throughout the contractual relationship."

Conduct ... that jeopardizes the insured's claim to excess coverage can give rise to bad faith liability, regardless of whether the primary policy has been exhausted and the excess carrier's duty to pay has been triggered.

Under *Schwartz*, an excess insurer's unreasonable conduct prior to exhaustion of underlying policy limits "may breach the insurer's implied covenant not to impair [an] insured's right to receive benefits under the contract."

Other California cases have imposed bad faith liability on excess carriers for unreasonable conduct prior to exhaustion of primary policy benefits. In *Kelley v. British Commercial Insurance Company*, 221 Cal. App. 2d 554 (1963), an excess carrier was sued for "bad faith toward its insured in refusing to settle ... [a] claim within the limits of its [excess] policy." During trial, the primary insurer defended the case and offered to contribute its policy toward settlement, but the excess carrier refused to accept a settlement within the excess policy limits. After judgment was entered for an amount beyond the excess policy limits, a bad faith claim was brought against the excess carrier for its refusal to settle during trial, prior to exhaustion of the primary policy. The excess carrier argued that "it owed no duty of good faith toward its insured because it occupied the position of a secondary or excess carrier." *Kelley* rejected this argument, stating that the excess carrier "was well aware" of its potential liability, but "nevertheless took no active investigation of the claimant's injuries but chose to rely on the primary carrier ... to investigate and defend the claim."

Indeed, when an insurance claim is likely to invade excess coverage, permitting the excess carrier to avoid its duty of good faith and fair dealing, including the duty to investigate and evaluate the claim, until the primary policy is exhausted, makes little sense. One California court explained as follows:

"The primary insurer is assisted, not impeded, by the active participation of another carrier with a stake in the negotiations. Self-interest may impel the primary carrier to take the lead when the settlement value is well within its policy limits, the excess carrier when the claim invades its own policy exposure. When settlement value hovers on the fringes of both policies, both carriers may collaborate." *Diamond Heights Homeowners Association v. National American Insurance Company*, 227 Cal. App. 3d 563, 576 (1991).

Thus, under California law, where an insured makes a claim that has a reasonable potential of requiring excess coverage, the duty of good faith and fair dealing attaches. The excess carrier cannot act in manner that unreasonably damages the insured's contractual rights, regardless of whether the primary insurance has been exhausted and the excess carrier's duty to pay has been triggered.