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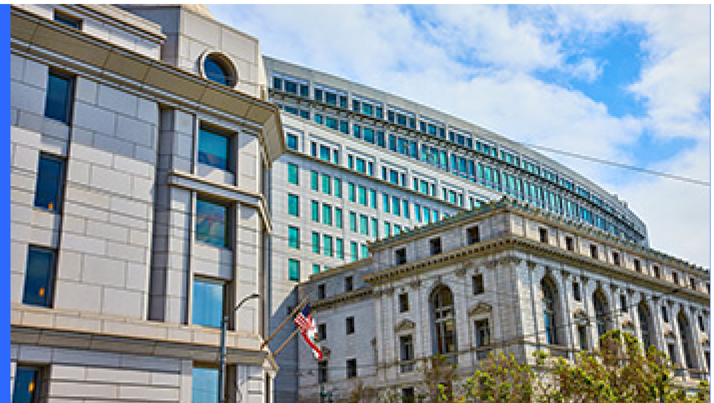

Appellate & Constitutional Law Update July 27, 2026

California Supreme Court Holds That The Failure To Exhaust Underlying Policies Does Not Categorically Preclude An Insured's Claims Against An Excess Insurer

***Fox Paine & Co. v. Twin City Fire Insurance Co.*, S287404** – Decided July 27, 2026

The California Supreme Court unanimously held today that an insured may pursue claims for declaratory relief and tortious breach of the implied covenant of good faith and fair dealing against excess insurers even where the insurance coverage underlying the excess policies has not yet been exhausted.

"[A] lack of exhaustion does not categorically make a coverage dispute involving an excess policy unduly abstract or hypothetical."

CHIEF JUSTICE GUERRERO, WRITING FOR THE COURT

Background:

Excess insurance policies provide coverage after the limits of underlying policies have been exhausted. The policies' exhaustion provisions determine when the excess insurer becomes obligated to pay a covered loss. Fox Paine & Co. and related parties bought a $10 million primary professional-liability policy and four successive $10 million excess layers. After a business dispute between Fox Paine's principals generated extensive litigation, the primary insurer paid its $10 million limits to one group of insureds. The Fox Paine plaintiffs then sought coverage for their litigation-related losses and sued the excess insurers for declaratory relief (on coverage) and breach of the implied covenant of good faith and fair dealing.

The trial court allowed the claims involving the first excess layer to proceed past a demurrer because the primary policy had allegedly been exhausted, but it dismissed the claims against the insurers that issued the second through fourth excess layers, ruling that the plaintiffs had not alleged exhaustion of the policies underlying the higher layers. The Court of Appeal affirmed, holding that no obligations arose under the higher-layer excess policies before exhaustion of the underlying policies and that declaratory relief was neither necessary nor appropriate while the claims against the first-layer insurer remained unresolved.

Issues Presented:

(1) When a policyholder alleges losses sufficient to reach an excess policy, but the underlying insurance layers have not yet been exhausted, may the policyholder nevertheless seek declaratory relief against the excess insurer?

(2) May a policyholder state a claim against an excess insurer for bad faith before the underlying policy layers have been exhausted?

Court's Holdings:

Yes, as to both:

(1) Exhaustion of underlying insurance is not categorically necessary to plead an actual controversy supporting declaratory relief against an excess insurer, but to survive demurrer the plaintiff still must make sufficient allegations of either actual or reasonably likely attachment of coverage under the excess policy.

(2) An insured suing an excess insurer for bad faith need not allege prior exhaustion of all underlying insurance; it is enough to allege facts showing that coverage under the excess policy will attach, or would attach but for the insurer's bad-faith conduct, and that the insurer's misconduct has impaired the insured's recovery of policy benefits.

What It Means:

- The decision is significant for policyholders with layered insurance coverage. The Court rejected a strict exhaustion prerequisite that would have obligated insureds to scale the coverage tower through policy-by-policy lawsuits, reasoning that a single action resolving coverage across the tower avoids serial litigation and the risk of inconsistent rulings.

- Ordinarily, an insured must "allege a covered loss that reaches an excess policy's attachment point in order to state an actual controversy involving that policy" sufficient to support declaratory relief. But "additional considerations" may warrant application of a more lenient standard requiring only a "reasonable likelihood" of attachment—for instance, where mounting losses or liabilities have not yet been fully ascertained, or where it is uncertain how much other insureds' claims will draw upon (and help exhaust) lower-layer policies.
- Under either standard, precision matters: the Court disapproved earlier decisions suggesting that no covered-loss allegation is required, and it faulted plaintiffs for commingling covered loss with prejudgment interest because only covered loss counts toward exhaustion and can cause higher-layer policies to attach.
- The Court cautioned that a trial court's discretion under Code of Civil Procedure section 1061 to decline declaratory relief "is not boundless." Where a complaint shows that declaratory relief would be appropriate, a trial court may not refuse to entertain the action.
- For excess insurers, the decision confirms that the implied covenant of good faith and fair dealing operates from the inception of the policy, not merely once the policy attaches. Conduct occurring before exhaustion, such as allegedly favoring rival claimants or concealing coverage decisions and settlements from the insured, can give rise to tort liability.
- The Court left several questions for remand, including which pleading standard governs plaintiffs' declaratory relief claims, whether plaintiffs' allegations satisfy it, and whether plaintiffs have alleged unreasonable conduct amounting to bad faith. The Court also reserved the question whether, "in unusual circumstances involving consequential harm to an insured," a bad-faith claim should be permitted even if there is no coverage under an insurance policy.

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The Court's opinion is available here.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding developments at the California Supreme Court. Please feel free to contact the following practice group leaders:

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