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Some insurance companies are changing policy language to prevent excess coverage from being triggered in the event of settlement with underlying policies.

Don't Settle Away Your Excess Insurance Coverage

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For decades, excess liability insurance policies provided that excess insurers were not required to pay out unless the full limits of underlying insurance were exhausted "in the payment of claims" or by "actual payments." Based on this and similar language, excess insurance companies argued that if the policyholder settled its claim with the underlying insurer for less than the underlying insurance company's limits, its excess coverage was not triggered. Prior to 1928, some courts found in favor of excess insurance companies on this issue, holding that the words "exhausted in the payment of claims" required actual cash payment of full primary policy limits as a condition precedent to the right to recover excess insurance. In 1928, the Second Circuit, in *Zeig v. Mass. Bonding & Ins. Co.*, soundly rejected those holdings and the court's reasoning has been widely followed.[1]

Recently, however, in response to *Zeig* and its progeny, excess insurance companies have begun to alter their policy language in various ways to avoid payment where anything less than full limits are actually paid out by the underlying insurance company. In certain jurisdictions, their efforts have been met with some success. Three cases in particular demonstrate this transition: in California, *Qualcomm Inc. v. Certain Underwriters at Lloyd's, London*; in Texas, *Citigroup Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA*; and in Illinois, *Great Am. Ins. Co. v. Bally Total Fitness Holding Corp.*[2] In the wake of these recent decisions, it is imperative that policyholders be made aware of how courts currently are interpreting excess liability policies and what precautions they can take to ensure that their excess coverage remains viable in this new legal landscape.

The first part of this article will discuss the Second Circuit's bellwether opinion in *Zeig* and its long trail of supporting case law. The second part will discuss recent opinions across the country that have gone against the rule in *Zeig*, based on the insurance industry's change in standard policy language. The third and final part of this article will focus on what steps today's policyholder must take in order to preserve excess coverage in the wake of this changing law.

The *Zeig* Rule and Its Progeny

For the last eight decades, an overwhelming majority of courts, including every circuit court of appeals that has confronted the issue, found that a policyholder's settlement with an underlying insurance company for less than its limit of liability still triggers the excess insurer's coverage, provided that the loss exceeded the underlying insurer's limits. It was in the seminal case of *Zeig,* however, that Judge Augustus N. Hand of the Second Circuit held that the excess insurance company must pay the amount of liability within its layer of coverage *irrespective of how the underlying insurer has satisfied its payment obligation.*

The policyholder in *Zeig* suffered a burglary, and though it had $15,000 in underlying coverage, it settled with its three underlying insurers for $6,000, releasing them from any further payment obligation.[3] The policyholder then sought coverage from its fourth-layer excess insurance company, which provided for another $5,000 in coverage. The excess insurer, however, denied coverage, asserting that the terms of its policy only obligated it to pay once the underlying insurance was fully paid out, which it was not.[4] The clause at issue provided that the policy was issued:

> [a]s excess and not contributing insurance, and shall apply and cover only after all other insurance herein referred to shall have been exhausted in the payment of claims to the full amount of the expressed limits of such other insurance.

The trial court agreed with Zeig's excess insurance company and held, as a matter of law, that the underlying policies had not been exhausted in the payment of claims to the full amount of the expressed limits. Accordingly, the court directed judgment in the favor of the defendant.

In reversing the lower court, the Second Circuit found that "[s]uch a construction of the policy … seems unnecessarily stringent."[5] The court held that the subject clause should not be interpreted to place such an undue burden on the policyholder before it could seek its excess coverage.

> Nothing is said about the "collection" of the full amount of the primary insurance. The clause provides only that it be "exhausted in the payment of claims to the full amount of the expressed limits." The claims are paid to the full amount of the policies, if they are settled and discharged, and the primary insurance is thereby exhausted. There is no need of interpreting the word "payment" as only relating to payment in cash. It is often used as meaning the satisfaction of a claim by compromise, or in other ways.[6]

Aside from policy interpretation, Judge Hand also looked at the public policy implications of requiring the policyholder to always obtain the full limits of its underlying insurance before triggering excess insurance coverage.

> To require an absolute collection of the primary insurance to its full limit would in many, if not most, cases involve delay, promote litigation, and prevent an adjustment of disputes which is both convenient and commendable. A result harmful to the insured, and of no rational advantage to the insurer, ought only to be reached when the terms of the contract demand it.[7]

Accordingly, the court held that even if a policyholder reaches a settlement with its underlying insurance company for an amount within its limits, the policyholder may still recover from its excess insurance company as long as the loss is in excess of the underlying insurer's limits and the policyholder paid the difference between the settlement amount and the underlying limit.

The rule set forth in *Zeig* was affirmed under New York law as recently as 2006, in *Pereira v. National Union Fire Insurance Co. of Pittsburgh, PA*, even though the language of the policy in *Pereira* was more specific than that of the policy in *Zeig*.[8] In *Pereira*, the excess insurance policy at issue provided that coverage would attach "only after all Underlying Insurance has been exhausted by *actual payment* of claims or losses thereunder …."[9] Despite the policy's requirement of "actual payment," the court held that the excess insurance company was obligated to pay even though the underlying insurer had become insolvent and would, therefore, never make any payment.

Insurance companies have begun to alter the standard language in their excess policies to specify the manner in which the underlying insurance must be exhausted.

Zeig's influence has stretched far beyond New York to jurisdictions across the country, standing for the principle that settlement within the limits of the underlying policy does not relieve an excess insurance company from paying for a loss that reaches its layer of coverage.[10] For instance, in *Koppers Co. v. Aetna Casualty & Surety Co.*, the Third Circuit held that when a policyholder settles with its underlying insurance company for less than full policy limits, the settlement effectively exhausts the underlying insurance, triggering the excess insurer's obligation to pay.[11] As long as the policyholder absorbs the difference between the settlement amount and the underlying policy limit, the *Zeig* rule "encourages settlement and allows the insured to obtain the benefit of its bargain with the excess insurer, while at the same time preventing the insured from obtaining a double recovery."[12]

The Insurance Industry's Response

In *Zeig*, Judge Hand could not conceive that an excess insurance company, which has been paid substantial premiums, could walk away from its contractual obligations solely because its policyholder sought to avoid litigation and settled with the underlying insurers. He wrote that such "[a] harmful result to the insured … ought only to be reached when the terms of the contract demand it."[13] Accordingly, insurance companies have begun to alter the standard language in their excess policies to specify the manner in which the underlying insurance must be exhausted and have succeeded in obtaining this "harmful result" in several jurisdictions.

This change in established precedent began with the United States District Court for the Eastern District of Michigan's opinion in *Comerica Inc. v. Zurich American Insurance Co.*[14] In *Comerica*, the corporate policyholder plaintiff settled five securities fraud class action lawsuits for $21 million.[15] The plaintiff's primary insurance company had disputed coverage, but eventually agreed to pay $14 million of its $20 million limit in exchange for being discharged from all subsequent liability. The plaintiff's follow form excess insurance policy provided that "[c]overage hereunder shall attach only after all such 'Underlying Insurance' has been reduced or exhausted by payments for losses …."[16] The court held that the excess policy language unambiguously required that the primary insurance be exhausted by the actual payment of losses by the primary insurance company, and plaintiff's payment to make up the difference did not trigger excess coverage. The court stated, "Payments by the insured to fill the gap [and] settlements that extinguish liability up to the primary insurer's limits … are not the same as actual payment."[17]

Similarly, in *Qualcomm*, the excess directors and officers (D&O) insurance policy at issue provided that the excess insurer "shall be liable only after the insurers under each of the Underlying Policies have paid or have been held liable to pay the full amount of the Underlying Limit of Liability."[18] The California Court of Appeal held that the phrase "have paid … the full amount of the Underlying Limit" could not have any other reasonable meaning than actual payment of no less than the full $20 million underlying limit by the underlying insurers.[19] Moreover, the court in *Qualcomm* specifically criticized the *Zeig* court's focus on public policy considerations in favor of the plain meaning of unambiguous contractual terms.

In the wake of *Comerica* and *Qualcomm*, several courts have held that where the plain terms of the excess insurance policy clearly define how underlying insurance is to be exhausted, excess coverage is not triggered if the actual exhaustion deviates from the specified method; for example, by the policyholder paying the difference.[20]

In *Bally Total Fitness*, the court specifically distinguished the Second Circuit's decision in *Zeig*, and instead followed the court's decision in *Comerica* in holding that the policy language of the excess policies at issue clearly defined how the underlying insurance must be exhausted.[21] The third-layer excess policy provided that liability would attach "only after the insurers of the Underlying Policies … have paid, in … legal currency, the full amount of the Underlying Limit," while the fourth-layer excess policy defined exhaustion as the "actual payment of loss or losses thereunder" by "all Underlying Insurance."[22] Moreover, the court noted with importance that the limits of the underlying insurance policies (i.e., $40 million) were defined in the policy.

While a pro-insurance-company trend appears to be forming on this issue, not all courts have adopted the reasoning in *Comerica* and *Qualcomm*. Indeed, at least one recent decision held that the rule set forth in *Zeig* and its progeny is still the proper course. In *HLTH Corp. v. Agricultural Excess and Surplus Ins. Co.*, the plaintiff's excess D&O insurance policy provided that excess coverage would apply:

> *[o]nly in the event of exhaustion of the Underlying Limit by reason of the insurers of the Underlying Insurance*, or the insureds in the event of financial impairment or insolvency of an insurer of the Underlying Insurance, paying in legal currency loss which, except for the amount thereof, would have been covered hereunder.[23]

The court found that even though the excess policy's language required that the full amount of underlying insurance be paid by the underlying insurer, established case law mandated that any loss in excess of the underlying limit, regardless of plaintiff's settlement for a lesser amount, exhausted the underlying policies as a matter of law. Moreover, the court addressed the public policy implications of following the reasoning set forth in *Comerica* and *Qualcomm* and endorsed *Zeig*'s "functional exhaustion" approach, stating:

> Settlements avoid costly and needless delays and are desirable alternatives to litigation where both parties can agree to payment and leave the other separately underwritten risks unchanged. The Court sees unfairness in allowing the excess insurance companies in the instant case to avoid payment on an otherwise undisputedly legitimate claim.[24]

Nevertheless, in a number of jurisdictions, excess insurance companies have successfully evaded payment by changing their standard forms to avoid triggering their coverage where the policyholder settles with its underlying insurer for less than full limits, and policyholders need to take steps to avoid this potential pitfall.

Vigilance begins at the procurement stage.

How to Avoid This "Harmful Result"

In today's tumultuous and uncertain economy, it is sometimes advantageous for a corporate policyholder faced with mounting lawsuits to be able to settle with its primary insurance company, thereby avoiding protracted and costly litigation. The decisions in *Comerica* and *Qualcomm*, however, require a policyholder not only to litigate a dispute with its underlying insurer, but also to win the dispute and obtain the full underlying limit before it can obtain coverage from its excess insurer for a given loss. With the court's decision in *Citigroup*[25] currently on appeal before the Fifth Circuit Court of Appeals, it is now more important than ever to make sure your excess insurance policy provides the coverage for which you paid and reasonably expected.

Vigilance begins at the procurement stage. Be sure that your broker questions the excess underwriter about the language of the policy that deals with exhaustion of underlying limits. Require that the underwriter specify the language in its quotation so that you know exactly what you are buying. Avoid exhaustion provisions that require actual payment by underlying insurance companies of all underlying policy limits. Some examples of exhaustion provisions to be avoided include those that provide that excess coverage will attach only after:

- the insurers of the Underlying Limits shall have paid in legal currency the full amount of the Underlying Limit;[26]
- the insurers under each of the Underlying Policies have paid or have been held liable to pay the full amount of the Underlying Limit of Liability;[27] or
- the insurers of the Underlying Policies shall have paid in legal currency the full amount of the Underlying Limit for such Policy Period and the Company and/or the Insured Persons shall have paid the uninsured retention …. In the event and only in the event of the reduction or exhaustion of the Underlying Limit by reason of the insurers of the underlying Policies paying in legal currency Loss …. The risk of uncollectability of the Underlying Policies … for any reason, is expressly retained by the Insured Persons … and is not in any way or under any circumstances insured or assumed by the Insurer.[28]

If you are unsure whether the exhaustion provision being quoted to you is problematic, seek an endorsement to the excess policy that makes clear that the excess insurance will be triggered in the event that the policyholder settles a claim with its underlying insurance company for less than full limits, provided that the policyholder's loss exceeds underlying limits and is otherwise covered.

If you currently have an excess insurance policy with a potentially problematic exhaustion provision, contact your excess insurance companies before settling with any underlying insurer to gain their agreement that such a settlement will not impact your ability to recover under your excess coverage. The failure of any excess insurance company to so agree, and the attendant risk of forfeiting excess coverage, must be considered in deciding whether the settlement with the underlying insurer(s) should be entered into. In this situation, experienced coverage counsel should be contacted to provide you with an analysis of the merits of the excess insurer's position under applicable law.

Conclusion

The insurance industry has begun to respond to decades of precedent that required excess insurers to pay out on claims that reached excess layers of coverage, even though underlying insurers did not technically pay out their full limits. While in recent years these excess insurers have successfully avoided their coverage obligations in certain jurisdictions, there are steps you can take to avoid settling away the excess coverage for which you paid substantial premiums.

Endnotes

1 *Zeig v. Mass. Bonding & Ins. Co.*, 23 F.2d 665 (2d Cir. 1928).

2 *See, e.g.*, *Qualcomm Inc. v. Certain Underwriters at Lloyd's, London*, 161 Cal. App. 4th 184 (Ct. App. 2008); *Citigroup Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA*, 2010 WL 2179710 (S.D. Tex. May 28, 2010); *Great Am. Ins. Co. v. Bally Total Fitness Holding Corp.*, 2010 WL 2542191 (N.D. Ill. June 22, 2010).

3 *Zeig*, 23 F.2d at 665.

4 *Id.* at 666.

5 *Id.*

6 *Id.*

7 *Id.*

8 *Pereira v. National Union Fire Insurance Co. of Pittsburgh, PA.*, 2006 WL 1982789 (S.D.N.Y. July 12, 2006).

9 *Id.* at *7 (emphasis added).

10 *See, e.g.*, *Waste Mgmt. of Minn. Inc. v. Transcon. Ins. Co.*, 502 F.3d 769, 773 (8th Cir. 2007); *Elliot Co. v. Liberty Mut. Ins. Co.*, 434 F. Supp. 2d 483, 499-500 (N.D. Ohio 2006); *Archer Daniels Midland Co. v. Aon Risk Servs. Inc. of Minn.*, 356 F.3d 850, 859 (8th Cir. 2004); *Westinghouse Elec. Corp. v. Am. Home Assurance Co.*, 2004 WL 1878764, at *13 (N.J. Super. Ct. Law Div. July 8, 2004); *Reliance Ins. Co. v. Transamerica Ins. Co.*, 826 So.2d 998, 999 (Fla. Dist. Ct. App. 2001); *Chem. Leaman Tank Lines Inc. v. Aetna Cas. & Sur. Co.*, 177 F.3d 210, 227 (3d Cir. 1999); *Rummel v. Lexington Ins. Co.*, 945 P.2d 970, 981 (N.M. 1997); *Gould Inc. v. Arkwright Mut. Ins. Co.*, 1995 WL 807071, at *3 (M.D. Pa. Nov. 8, 1995); *Brodhead v. Dodgin*, 824 S.W.2d 616, 621 (Tex. Ct. App. 1991); *UNR Indus. Inc. v. Cont'l Cas. Co.*, 942 F.2d 1101, 1108 (7th Cir. 1991); *Kelly Co. v. Cent. Nat'l Ins. Co. of Omaha*, 662 F. Supp. 1284, 1288-89 (E.D. Wisc. 1987); *Stargatt v. Fidelity & Cas. Co. of N.Y.*, 67 F.R.D. 689, 691 (D. Del. 1975).

11 *Koppers Co. v. Aetna Casualty & Surety Co.*, 98 F. 3d 1140 (3d Cir. 1996).

12 *Id.* at 1454.

13 *Zeig*, 23 F.2d at 666.

14 *Comerica Inc. v. Zurich American Insurance Co.*, 498 F. Supp. 2d 1019 (E.D. Mich. 2007).
15 *Id.* at 1025-26.
16 *Id.* at 1022.
17 *Id.* at 1032.
18 *Qualcomm*, 161 Cal. App. 4th at 189 (emphasis added).
19 *Id.* at 195.
20 *See, e.g., Trinity Homes LLC v. Ohio Cas. Ins. Co.*, 2009 WL 3163108, at *39 (S.D. Ind. Sept. 25, 2009) (holding that underlying insurance must be exhausted by the underlying insurance company where policy stated that underlying limits must be "exhausted or depleted by the actual payment of losses by the underlying insurer"); *Citigroup*, 2010 WL 2179710 at *2 (finding where multiple excess insurers' policies all provided that underlying limit must be paid by underlying insurer, policyholder could not circumvent unambiguous payment requirement by settling with underlying insurer); *Schmitz v. Great Am. Assurance Co.*, 2010 WL 2160748, at *11-12 (Mo. App. Ct. June 1, 2010) (holding that excess insurer's coverage was not triggered where policy provided that its coverage would apply only if "the 'Underlying Limits of Insurance' … are … *exhausted solely by payment of [sums actually paid in settlement or satisfaction of a claim*]") (emphasis in original); *Bally Total Fitness*, 2010 WL 2542191.
21 *Bally Total Fitness*, 2010 WL 2542191 at *5.
22 *Id.*
23 *HLTH Corp. v. Agricultural Excess and Surplus Ins. Co.*, 2008 WL 3413327 at *14 (Del. Super. Ct. July 31, 2008) (emphasis added).
24 *Id.* at 15.
25 *Citigroup*, 2010 WL 2179710.
26 Federal Insurance Company, Excess Policy, Insuring Agreement, Form 14-02-2272 (ed. 5/97), page 1 of 6.
27 Lloyd's Excess Directors and Officers and Company Reimbursement Indemnity Policy, Limits of Liability, ¶ IV(C).
28 Old Republic Insurance Company, Excess Directors and Officers Liability and Reimbursement Coverage, Form ORUG-50 (6/2001).

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