New York Law Journal

SERVING THE BENCH AND BAR SINCE 1888

WWW.NYLJ.COM

An ALM Publication

VOLUME 245—NO. 125

THURSDAY, JUNE 30, 2011

CORPORATE INSURANCE LAW

Expert Analysis

'Zeig' Still Governs Exhaustion Of Underlying Policy Limits in New York

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The Annual Bar Dinner, held at the Waldorf Astoria on Dec. 13, 1951, honored Judges (and cousins) Learned and Augustus Hand. In a speech paying tribute to the honorees, U.S. Supreme Court Justice Robert H. Jackson said that if he was "to write a prescription for becoming the perfect district judge, it would be always to quote Learned and always to follow Gus."[1] As he went on to explain, the Hands "have represented an independent and intellectually honest judiciary at its best. And the test of an independent judiciary is a simple one—the one you would apply in choosing an umpire for a baseball game. What do you ask of him? You do not ask that he shall never make a mistake or always agree with you, or always support the home team. You want an umpire who calls them as he sees them. And that is what the profession has admired in the Hands."

On Jan. 9, 1928, Judge Augustus Hand, then sitting on the U.S. Court of Appeals for the Second Circuit, called it as he saw it in *Zeig v. Massachusetts Bonding & Ins. Co.*,[2] and to this day courts across the nation have followed and continue to follow this seminal decision on triggering excess insurance. In the last few years, however, several courts have taken the time to reexamine *Zeig*. While a few courts, most notably in California, have questioned Judge Hand's rationale and strayed from *Zeig's* holding, most courts, including most notably the Southern District of New York and the U.S. Court of Appeals for the Seventh Circuit, have reaffirmed *Zeig's* guiding principles.

The 'Zeig' Decision

Typically, excess insurance policies contain provisions stating, in some manner, that the policies are not triggered until the underlying policies have been exhausted through payment of the underlying policy limits. The question that arises frequently is whether an excess policy can be triggered where the insured has settled with the underlying insurers for less than the policy limits. Faced with this issue in *Zeig*, the Second Circuit held that underlying policies could be exhausted through settlement for less than underlying policy limits, but that the excess policy would only cover the insured's loss in excess of the underlying limits.[3]

In *Zeig*, the insured had three underlying burglary insurance policies with combined limits of $15,000. The insured settled its claims under these policies for $6,000 and sought additional payment from its excess insurer. The excess carrier denied coverage on the grounds that the insured had not actually collected the full $15,000 in underlying coverage. Accordingly, the carrier argued, the underlying layers had not been "exhausted in the payment of claims to the full amount of the expressed limits of such other insurance" as required by the language of the excess policy. The Second Circuit disagreed and held that such policy language was ambiguous because the term "payment" need not be interpreted only as "payment in cash," but could also connote "satisfaction of a claim by compromise," such as the settlement of a claim for less than policy limits.[4]

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Judge Hand expressed concern that requiring collection of the full amount of the underlying insurance would unduly burden the insured by promoting litigation and preventing settlement, while being of "no rational advantage" to the excess insurer who, in any event, would only be called upon to pay that portion of the loss in excess of the underlying limits. The court explained that such an "unnecessarily stringent" construction of the policy should only be reached "where the terms of the contract demand it." Holding that the terms of the policy at issue did not require such stringent construction, the court ruled that the insured should have been given the opportunity to prove that the amount of his loss exceeded the underlying limits, and if so, to recover the excess.

Following 'Zeig'

Over the years since 1928, the *Zeig* decision has become the leading decision on this issue, followed by numerous courts in jurisdictions across the country.[5] As the Second Circuit did in *Zeig*, other courts continue to pay lip service to the black letter law of insurance policy construction which provides that the plain meaning of the words govern the interpretation of the policy. At the same time, these courts have also relied on *Zeig's* public policy reasoning and refused to construe the policy language to require the actual collection of full payment of underlying limits.

Courts following *Zeig* have found the "exhaustion" requirement to be satisfied by what they term the "functional" or "virtual" exhaustion of underlying limits and a concept described as "settlement with credit"—which permits the insured to settle its underlying policies for less than the total limits but gives the excess carrier credit for the remaining amount of the limits, with the insured bearing the cost of the difference.[6] For example, citing to *Zeig* in 1996, the U.S. Court of Appeals for the Third Circuit held in *Koppers Co. v. Aetna Cas. & Sur. Co.* that "settlement with the primary insurer functionally 'exhausts' primary coverage and therefore triggers the excess policy—though by settling the policyholder loses any right to coverage of the difference between the settlement amount and the primary policy's limits."[7]

Questioning 'Zeig'

While occasional decisions over the years declined to follow *Zeig*, acceptance of *Zeig* was at one point so widespread that the insured in a recent California case, *Qualcomm Inc. v. Certain Underwriters at Lloyds London*, argued that to interpret the language of its excess insurance policy, the court must "charge" the insurer

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with knowledge of such judicial construction, arguing that "the parties' economic bargain and reasonable expectations were shaped by *Zeig* and its progeny."[8] Unfortunately for the insured, the California Court of Appeals is one of the courts that have recently departed from the *Zeig* line of cases, holding that exhaustion by payment of underlying limits means just what it says—that underlying limits must be actually "paid" before the excess coverage is triggered.[9]

Like the *Qualcomm* court, the district courts for the Eastern District of Michigan and the Northern District of Illinois, in *Comerica Inc. v. Zurich American Ins. Co.* and *Great American Ins. Co. v. Bally Total Fitness Holding Corp.* differentiated their holdings from *Zeig*, finding that the terms in the policies before them unambiguously required the actual payment of full underlying limits. Although the excess carriers in those cases argued that their policies contained more precise language regarding exhaustion of underlying limits, it is not at all clear that the policy terms were significantly different from the policy terms in *Zeig* or the cases following *Zeig*.

Instead, it appears that these courts have rejected the *Zeig* rationale outright—disagreeing that the exhaustion language in the excess policies is ambiguous and refusing to base their rulings upon public policy considerations in favor of the insured. The *Qualcomm* decision, in fact, directly rejected the *Zeig* ruling, stating that the *Zeig* "court appeared to place policy considerations (i.e., the promotion of convenient settlement or adjustment of disputes) above the plain meaning of the terms of the excess policy and for that reason…we reject its reasoning."

The court further disagreed with what it called *Zeig's* "strained interpretation of the word 'payment,'" finding that a "'settlement plus credit' does not constitute 'payment' of liability limits as that term is commonly and ordinarily understood."[10] Similarly, in *Citigroup Inc. v. Nat'l Union Fire Ins. Co. of Pitt.*, the Southern District of Texas rejected the insured's argument, holding that "the unambiguous terms of the policies prevent Citigroup from circumventing the payment requirement by functional exhaustion—a label without substance or rigor."[11]

'Zeig's' Continuing Influence

In the wake of these decisions and amid insurers' attempts to fashion more precise policy language, commentators predicted a chipping away at *Zeig* and expressed concern for policyholders who now face the threat of a denial of coverage under their excess policies should they dare to settle with their underlying carriers for less than the full policy limits. These concerns, however, have been somewhat abated by other recent decisions, some of which have expressly rejected the *Qualcomm* reasoning and affirmed commitment to the *Zeig* rationale.[12]

Most significantly, the Seventh Circuit, in *Trinity Homes LLC v. Ohio Cas. Ins. Co.,* recently found an exhaustion provision to be ambiguous, citing to *Zeig* and *Koppers*, and explaining that "our sister circuits have dealt with similar umbrella policies." The court echoed the *Zeig* reasoning, expressing concern with the interpretation of exhaustion provisions in a manner that discourages settlement, but not going so far as to reject the *Qualcomm* and *Comerica* holdings, merely differentiating them instead based on the policy language.[13] In *HLTH Corp.*, however, the Superior Court of Delaware expressly "decline[d] to accept the reasoning set forth in *Qualcomm*…or in *Comerica*…as the opinions in both of these cases are contrary to that of *Zeig* and its progeny…."[14]

'Zeig's' Authority in New York

In New York, *Zeig* was most recently followed by the Southern District in *Pereira v. Nat'l Union Fire ins. Co. of Pitt, PA* in 2006. The *Pereira* court held that an exhaustion clause providing that the excess policy will pay only after the "Underlying Insurance has been exhausted by actual payment of claims or losses thereunder" was ambiguous where an underlying insurer was insolvent and would, therefore, never actually pay its limits. The excess insurer argued that this clause plainly meant that the excess policy had no obligation to pay unless the underlying policies had been exhausted through actual payment of their limits.

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The *Pereira* court disagreed, finding that while that might be one reasonable interpretation of the policy language, the court "cannot conclude that it is the only reasonable interpretation." The court then reviewed the *Zeig* ruling and concluded that the policy should not be interpreted to "excuse the excess insurers from providing coverage within their respective layers." The court expressed concern that such an interpretation would "work a hardship on the insureds, who have already been deprived of a layer of coverage by the insolvency, and provide a windfall to the excess insurers."[15]

Although this decision has not been challenged in New York, in *Comerica*, the District Court for the Eastern District of Michigan specifically took issue with the *Pereira* holding, taking the position that there was no ambiguity in the policy language at issue in *Pereira* and no other reasonable interpretation of the plain language.[16] In reaching its determination as to "very similar language," the *Comerica* court refused to "rewrite" the insurance agreement to allow for exhaustion by anything other than actual payment.

Limits Shaving Endorsements

In light of *Zeig* as well as the contrary rulings, some insurance carriers have sought to clarify their policies by adding language intended to more precisely explain that excess coverage is not triggered in the absence of actual payment of full underlying policy limits. Other carriers, particularly in the context of D&O policies, have introduced limits shaving endorsements. These endorsements expressly recognize the insured's right, consistent with *Zeig*, to trigger excess coverage through payment of the underlying limits by the primary carrier and/or the insured. Thus, policies that contain a limits shaving endorsement authorize the insured to enter into settlement with the primary carrier for less than the total limits, absorb the remaining primary limits and then seek additional coverage from the excess carrier, provided the loss exceeds the primary limits.

Conclusion

To date, New York courts have given no indication of wavering from *Zeig*. However, a case currently pending in the Southern District may provide the opportunity to once again revisit these issues. In *Lexington Ins. Co. v. Tokio Marine*, the parties have filed motions regarding the application of *Zeig* and whether settlement payments made were properly allocable to the primary or excess layers of coverage.[17] In addition, defense counsel has cited to the *Qualcomm*, *Comerica*, *Bally* and *Citigroup* decisions, which refused to follow *Zeig*.

Nevertheless, as we look back to 1928, it seems clear that Judge Hand called it as he saw it and to this day, over 80 years later, courts in New York and across the nation still follow *Zeig*.

1. http://www.roberthjackson.org/the-man/bibliography/why-learned-and-augustus-hand-became-great/.
2. *Zeig v. Massachusetts Bonding & Ins. Co.*, 23 F.2d 665 (2d Cir. 1928).
3. Id.
4. Id.
5. See, e.g., *Rummel v. Lexington Ins. Co.*, 123 N.M. 752 (1997); see also, *Stargatt v. Fidelity & Cas. Co. of N.Y.*, 67 F.R.D. 689 (D.Del. 1975), *Gasquet v. Commercial Union Ins. Co.*, 391 So.2d 466 (Ct. App. La. 1980).
6. *UMC/Stamford Inc. v, Allianz Underwriters Insurance Co.*, 647 A.2d 182, 190 (N.J. Super. 1994)
7. *Koppers Co. v. Aetna Cas. & Sur. Co.*, 98 F.3d 1440, 1454 (3d Cir. 1996).
8. *Qualcomm Inc. v. Certain Underwriters at Lloyds London*, 161 Cal.App.4th 184, 192-193 (Cal. Ct. App. 2008).
9. Id., *Comerica Inc. v. Zurich American Ins. Co.*, 498 F.Supp.2d 1019 (E.D.Mich. 2007); *Great American Ins. Co. v. Bally Total Fitness Holding Corp.*, 2010 WL 2542191 (N.D.Ill. June 22, 2010).
10. *Qualcomm*, 161 Cal.App.4th 184 at 197-98.
11. *Citigroup Inc. v. Nat'l Union Fire Ins. Co. of Pitt.*, 2010 WL 2179710 (May 28, 2010).
12. See, e.g., *Trinity Homes LLC v. Ohio Cas. Ins. Co.*, 629 F.3d 653 (7th Cir. 2010); *HLTH Corp. v. Agricultural Excess & Surplus Ins. Co.*, 2008 WL 3413327 (Del. Super. July 31, 2008); *Schmitz v. Great American Assurance Co.*, 2011 WL 1565447 (Mo. April 26, 2011); *Pacific Employers Ins. Co. v. Clean Harbors Env. Svcs Inc.*, 2011 WL 813925 (N.D.Ill. Feb. 24, 2011); *Lightfoot v. Hartford Fire Ins. Co.*, 2011 WL 197982 (E.D.La. Jan. 20, 2011).
13. *Trinity Homes*, 629 F.3d at 658-59.
14. *HLTH Corp.*, 2008 WL 3413327 at *15.
15. *Pereira v. Nat'l Union Fire ins. Co. of Pitt, PA*, 2006 WL 1982789 at *7 (SDNY July 12, 2006).
16. *Comerica*, 498 F.Supp.2d at 1033.
17. *Lexington Ins. Co. v. Tokio Marine & Nichido Fire Ins. Co.*, 11-cv-0391 (DAB).

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