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Expert Analysis

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New York Courts May Be Wavering on 'Zeig'

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In the June 2011 edition of this column,[1] we discussed the U.S. Court of Appeals for the Second Circuit's seminal decision in *Zeig v. Massachusetts Bonding & Ins. Co*., a widely followed decision from 1928 that addressed issues concerning the trigger of excess insurance.[2] The *Zeig* court held that an excess policy can be triggered as a result of a settlement between the insured and its primary carriers, even where the settlement payment is less than the full limits of the primary insurance, as long as the insured's loss exceeds the primary limits. In such circumstances, the excess policy does not drop down below the attachment point, but it does cover loss incurred above the underlying limits.

We observed that courts in certain other jurisdictions had recently begun to call the *Zeig* decision into question, but we noted that New York courts continued to follow *Zeig*. Specifically, we reviewed the Southern District's decision in *Pereira v. Nat'l Union Fire Ins. Co. of Pitt, PA*, which followed *Zeig*, holding that an excess policy would be triggered with regard to loss that exceeded the underlying limits where the underlying carrier was insolvent, and therefore would never actually pay out the underlying limits.[3]

On Sept. 28, 2011, however, Judge Richard J. Sullivan of the Southern District issued a ruling that directly conflicts with *Pereira* and, while it does not explicitly reject *Zeig*, it certainly seems to base its conclusion on a rejection of the *Zeig* rationale. Judge Sullivan's opinion in *Federal Ins. Co. v. The Estate of Irving Gould* is the first New York case to stray from *Zeig* and gives us reason to reconsider this topic while we wait for the Second Circuit to address this issue again.[4]

The 'Zeig' Decision

To briefly recap, in *Zeig*, the insured had three underlying 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 limits. Accordingly, the excess carrier argued that 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.[5]

The court 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 amount from the excess carrier.

Over the years, the *Zeig* decision became the leading decision on this issue nationwide.[6] Courts following *Zeig* found the "exhaustion" requirement to be satisfied by what they termed 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.[7] The U.S. Court of Appeals for the Seventh Circuit, for example, in *Trinity Homes*, recently found an exhaustion provision to be ambiguous, relying on the decisions of its "sister circuits" in *Zeig* and a U.S. Court of Appeals for the Third Circuit decision in *Koppers*.[8]

Recently, however, some courts have begun to depart from the *Zeig* line of cases. These courts have concluded that *Zeig's* policy considerations should not impact the interpretation of the unambiguous language of an insurance contract and that, by their plain language, excess policies that require exhaustion by "payment" of underlying limits are not triggered unless the underlying limits have actually been paid.[9]

The 'Gould' Decision

In *Gould*, Judge Sullivan of the Southern District joined the list of judges that have refused to follow the *Zeig* reasoning.[10] In *Gould*, the former directors and officers of Commodore International Limited, the makers of the Commodore 64 computer, sought coverage under Commodore's D&O policies with respect to litigation in which claimants sought $100 million in damages from the directors and officers.

Fortunately for the directors and officers, Commodore had purchased a tower of D&O insurance totaling $51 million, including a primary policy with limits of $10 million and eight layers of excess

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coverage. Unfortunately for the Commodore directors and officers, however, Reliance and Home Insurance, the carriers providing excess coverage at the first, third and fourth layers, became insolvent in 2001 and 2003. Though the damages claimed were clearly in excess of those layers, the remaining excess insurers denied coverage, arguing that their policies required exhaustion of the lower layer policies "solely as a result of payment of losses thereunder…."[11]

The Commodore directors and officers asked the court to enter a judgment declaring that the remaining excess policies were triggered once the insureds' obligations exceeded the limits of the underlying excess layers, regardless of whether the now insolvent carriers had actually paid those limits. Based on *Zeig* and *Pereira*, one would have expected the court to agree with the directors and officers and issue the declaration.

The *Gould* court, however, denied the motion of the directors and officers, holding, in no uncertain terms, that such relief "contradicts the plain language of the Excess Policies." Judge Sullivan ruled that the excess policies are not triggered "solely by the aggregation" of the insureds' losses because the "express language of these policies establishes a clear condition precedent to the attachment of the Excess Policies" that is not satisfied until there is actual payment of the underlying limits.[12]

The court rejected the directors' and officers' reliance on *Zeig* and *Koppers*, explaining that *Zeig* is distinguishable because it concerned a situation where the insured had settled with the primary insurers for less than the total limits, not a situation where the insurer of an underlying layer was insolvent and unable to pay. According to Judge Sullivan, *Zeig* and *Koppers* provided no guidance "because in those cases the insured agreed to accept partial reimbursement for his losses while maintaining responsibility for the uncompensated portion of his claim." In contrast, in *Gould*, "the liability covered by the insolvent insurers would not be discharged by payment or settlement, but would simply be bypassed."[13]

'Gould's' Departure From 'Zeig'

Although Judge Sullivan avoided expressly rejecting *Zeig*, it is difficult to read the *Gould* and *Zeig* cases without seeing a fundamental conflict. While the factual scenarios may be different, in both the *Zeig* and *Gould* scenarios, the insured would have borne responsibility for the unpaid portion of underlying limits and only sought to recover the loss that exceeded the excess carriers' attachment point.

Judge Sullivan made no attempt to reconcile his ruling with Judge Laura Taylor Swain's decision in *Pereira*, with which *Gould* directly conflicts. In *Pereira*, as in *Gould*, the insured sought to bypass lower levels of coverage due to the insolvency of the underlying insurer, Reliance. However, in *Pereira*, Judge Swain expressly reaffirmed the continuing precedential value of *Zeig* and, specifically, the relevance of *Zeig* to the facts at hand.[14]

After analyzing the *Zeig* decision in detail, Judge Swain 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" is ambiguous 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]

In the *Gould* decision, Judge Sullivan disregards this conflict, merely noting in a footnote that *Pereira* is distinguishable because the language in *Pereira* was "ambiguous with respect to whether 'actual payment' of underlying 'claims or losses' was necessary to trigger excess policy."[16] Strangely though, the *Pereira* language seems less ambiguous than the *Gould* language, as the policy in *Pereira* specifically requires "actual payment of claims or losses," whereas the policy in *Gould* only requires "payment of losses."

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It appears, instead, that the actual conflict is not about how to interpret the language of the policies, but whether the court chooses to strictly adhere to that interpretation regardless of context or whether the court is willing to review the facts of the case to determine whether there may be more than one "rational" explanation for the same or similar policy terms.

The *Zeig* and *Pereira* courts determined that it would be inequitable for the policyholder to lose the ability to trigger their excess coverage, especially in circumstances where the excess insurer is not being asked to drop down or cover any more than it would have had the underlying policy limits been actually exhausted by payment. On the other hand, the *Gould* court and the other courts that have questioned *Zeig* have rejected this insertion of public policy concerns into what they view as the interpretation of the simple, plain language of unambiguous policy provisions.

Looking Forward

Given the erosion of *Zeig's* influence in other jurisdictions, it should not be surprising that New York courts are re-examining the issues addressed in that decision. What is surprising is that *Gould*, the first case that has departed from *Zeig's* rationale, concerns a situation where the insured could not access the excess layers due to the insolvency of the insurers responsible for the underlying layers. In that situation, the insured's position is more sympathetic than the situation presented in *Zeig*, where the insured has settled with the underlying carriers for less than the total limits.

Nevertheless, as a result of *Gould* and *Pereira*, we now have two decisions in the Southern District that reach opposite conclusions in very similar circumstances. Consequently, it has become difficult to predict whether New York courts will remain true to the *Zeig* precedent or begin to find ways to chip away at its influence.

At least one other case currently awaits a decision in the Southern District as to these issues. In *Lexington Ins. Co. v. Tokio Marine*, a motion is pending regarding the application of *Zeig*, although it concerns the situation where the insured has settled for less than full policy limits, not the insolvency situation presented in *Gould* and *Pereira*.[17] It will be interesting to see how Judge Deborah A. Batts rules on the pending motion. In addition, notice of appeal was filed by the insureds in *Gould* in late November. Therefore, it appears that the Second Circuit will ultimately have the last word on the continuing viability of *Zeig* in New York.

1. Howard B. Epstein and Theodore A. Keyes, "Zeig Still Governs Exhaustion of Underlying Policy Limits in New York," New York Law Journal, Vol 245-No. 125, June 30, 2011.
2. *Zeig v. Massachusetts Bonding & Ins. Co.*, 23 F.2d 665 (2d Cir. 1928).
3. *Pereira v. Nat'l Union Fire Ins. Co. of Pitt, PA*, 2006 WL 1982789 at *7 (S.D.N.Y. July 12, 2006).
4. *Federal Ins. Co. v. the Estate of Irving Gould,* 1:10-cv-01160 (RJS), Memorandum & Order, 9/28/2011
5. *Zeig*, 23 F.2d at 666.
6. See, e.g., *Rummel v. Lexington Ins. Co.*, 123 N.M. 752 (1997); *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).
7. *UMC/Stamford Inc. v. Allianz Underwriters Insurance Co.*, 647 A.2d 182, 190 (N.J. Super. 1994).
8. *Trinity Homes LLC v. Ohio Cas. Ins. Co.*, 629 F.3d 653 (7th Cir. 2010); *Koppers Co. v. Aetna Cas. & Sur. Co.*, 98 F.3d 1440, 1454 (3d Cir. 1996).
9. *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); *Qualcomm Inc. v. Certain Underwriters at Lloyds London*, 161 Cal.App.4th 184, 192-193 (Cal. Ct. App. 2008).
10. *Federal Ins. Co. v. the Estate of Irving Gould*, 1:10-cv-01160 (RJS), 2011 WL 4552381 (S.D.N.Y. Sept. 28, 2011).
11. Id. at *1-2.
12. Id. at *6-7.
13. Id. at *7-8.
14. *Pereira*, 2006 WL 1982789 at *7.
15. Id..
16. *Gould*, 2011 WL 4552381 at *7, n.2.
17. *Lexington Ins. Co. v. Tokio Marine & Nichido Fire Ins. Co.*, 11-cv-0391 (DAB).

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