ACCESSING EXCESS COVERAGE AFTER SETTLEMENTS WITH OTHER INSURERS: AN OVERVIEW OF ZEIG/COMERICA EXHAUSTION ISSUES

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In recent years, there has been a greater focus on issues specific to accessing excess insurance coverage, as more policyholders with large long-tail liabilities move into their excess layers of coverage. One issue that can arise when a large coverage claim implicates both primary and excess policies is whether the policyholder can settle its claim with a primary or other underlying insurer for less than policy limits without the risk of jeopardizing its coverage with an excess insurer. In this situation, the excess insurer may point to provisions in the excess policy regarding exhaustion of underlying limits before coverage under the excess policy will attach and may argue that the settlement of the primary policy for less than limits is insufficient to exhaust the limits. This article addresses the risks associated with accessing excess coverage in this situation.

A. THE GUIDING PRECEDENT—ZEIG

A leading case on this issue is *Zeig v. Massachusetts Bonding & Insurance Co.*, 23 F.2d 665 (2d Cir. 1928). There, the policyholder settled with primary insurers for less than the underlying limits and then pursued the excess insurer for the remainder of the loss. At issue was language in the excess policy stating that coverage should not attach until the underlying insurance “shall have been exhausted in the payment of claims to the full amount of the expressed limits of such other insurance.” The Second Circuit held that the underlying limits were deemed exhausted by the settlement for purposes of triggering coverage under the excess policy, but limited the policyholder’s recovery under the excess policy to “[o]nly such portion of the loss as exceeded, not the cash settlement, but the limits of these [underlying] policies.” *Id.* at 666. The Second Circuit reasoned that the excess insurer “had no rational interest in whether the insured collected the full amount of the primary policies, so long as it was only called upon to pay such portion of the loss as was in excess of the limits of those policies.” *Id.*

Zeig and its progeny establish that when a policyholder settles with an underlying insurer for less than the policy limit but absorbs the difference between the settlement amount and the limit, the excess insurers’ obligations are triggered as if the underlying insurer had paid up to the full amount. The Zeig rule applies most clearly in cases where an excess policy’s language on exhaustion is ambiguous, but it also permits courts to interpret policy language broadly to find ambiguity in favor of policyholders—a result courts have found favorable for both practical and policy reasons. See Zeig, 23 F.2d at 666 (characterizing the excess insurers’ argument as “unnecessarily stringent” where the insurers argued that the policy language—which provided for exhaustion by “payment of claims to the full amount of the expressed limits of such other insurance”—required actual payment by the underlying insurer); see also Mass. Mut. Life Ins. Co., 2014 WL 3707989, at *8 (“[V]iewing the exhaustion clause less dogmatically and more practically works to everyone’s advantage, insured and insurer alike.”); HLTH Corp., 2008 WL 3413327, at *15 (“Settlements avoid costly and needless delays and are desirable alternatives to litigation where both parties can agree to payment and leave 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.”).

Courts continue to rely on the public policy reasoning laid out in Zeig as a basis for interpreting exhaustion clauses in excess policies. In Maximus, Inc. v. Twin City Fire Ins. Co., 856 F. Supp. 2d 797, 800-04 (E.D. Va. 2012), for example, the U.S. District Court for the Eastern District of Virginia held, “[I]n light of well-established principles of insurance contract interpretation and the substantial policy considerations articulated by Zeig and its progeny, [the policyholders’] settlements with the underlying insurers for less than the full limits of their respective policies and agreeing to fill the gap so that the
policy limits have been reached satisfies the [excess insurer] Policy’s exhaustion requirement.” Id. at 804. There, a policyholder sought $78.3 million from its five professional legal liability insurance carriers, and the policyholder settled with the primary insurer and the first two tiers of excess insurers for amounts less than the limits of coverage. Id. at 798. The next excess insurer, predictably, argued that the policyholder had not properly exhausted its underlying policies. In rejecting the insurer’s argument, the court articulated that Zeig “sets out an additional factor,” beyond traditional contract interpretation, “to be considered when interpreting an exhaustion provision”—that is, the public policy favoring settlements. Id. at 800. The court underscored that preventing the policyholder from filling the gap in the absence of unambiguous language prohibiting such would “involve delay, promote litigation, and prevent an adjustment of disputes which is both convenient and commendable.” Id. (quoting Zeig, 23 F.2d at 666).

Thus, ninety years later, Zeig remains good law. See Hopeman Bros., Inc. v. Cont’l Cas. Co., 307 F. Supp. 3d 433 (E.D. Va. 2018) (“Zeig, which remains a ‘seminal decision interpreting New York insurance law,’ . . . stands for the proposition that New York law permits an insured to fill the gap left by below-limits settlement with an underlying insurer” (internal citations omitted)); Lasorte v. Those Certain Underwriters at Lloyd’s Severally Subscribing to Policy Numbers 115NAP108111970, 115NAP109111970, 995 F. Supp. 2d 1134, 1143 (D. Mont. 2014) (confirming “[t]he court’s reasoning in Zeig remains good law in New York” and finding that where “exhaustion” was not specifically defined, it was ambiguous and Zeig thus permitted exhaustion through a below-limit settlement where the policyholder filled the gap between the settlement and the attachment point for the excess coverage).

B. CONTRARY AUTHORITY—COMERICA LINE OF DECISIONS

Some courts, however, have held that a below-limits settlement with an underlying insurer prevents the settling policyholder from recovering under an excess policy, even though the settling policyholder provided a credit to the excess insurer for the full amount of the underlying limits. Comerica Inc. v. Zurich Am. Ins. Co., 498 F. Supp. 2d 1019 (E.D. Mich. 2007); Qualcomm, Inc. v. Certain Underwriters at Lloyd’s, London, 73 Cal. Rptr. 3d 770 (Cal. Ct. App. 2008). These decisions relied on a literal reading of language in the excess policies that required, as a condition of the attachment
of the excess coverage, exhaustion of the underlying policy’s limits by actual payment of loss by the underlying insurer. See Comerica, 498 F. Supp. 2d at 1032 (“Zurich’s policy requires ‘actual payment of losses’ by the underlying insurer and states that its ‘policy does not provide coverage for any loss not covered by the “Underlying Insurance” except and to the extent that such loss is not paid under the “Underlying Insurance” solely by reason of the reduction or exhaustion of the available “Underlying Insurance” through payments of loss thereunder.’”); Qualcomm, 73 Cal. Rptr. 3d at 778 (policy stated, “Underwriters 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.”).


Courts following Comerica and Qualcomm have found that the Zeig default rule can be overcome by clear and unambiguous policy language that requires underlying insurance carriers themselves to pay the full amounts of their policy limits to trigger coverage. These decisions highlight language in Zeig commenting “[i]t is doubtless true that the parties could impose such a condition precedent to liability upon the policy, if they chose to do so.” Comerica, 498 F. Supp. 2d at 1030 (quoting Zeig, 23 F.2d at 666). In one case, the U.S. District Court for the Eastern District of Ohio read the following policy language to plainly set a condition precedent to excess coverage that required payment of policy limits by the underlying insurer: “Coverage hereunder shall attach only after the insurers of the Underlying Insurance shall have paid in legal currency the full amount of the Underlying Limit.” Goodyear Tire and
Rubber Co., 694 F.3d at 782. The court reasoned that the insurer undisputedly did not agree to provide coverage that attached upon settlement for a below-limit sum, and the policy language did not permit the policyholder to credit the difference in the event of below-limit settlement. Id. at 783.

Other courts have prevented policyholders from filling the gap when the excess policies contained exhaustion language similar to that in Goodyear. See Martin Res. Mgmt. Corp, 803 F.3d at 769 (“The Insurance afforded under this Policy shall apply only after all applicable Underlying Insurance . . . has been exhausted by actual payment under such Underlying Insurance.”) (emphasis added); Bally Total Fitness Holding Corp., 2010 WL 2542191, at *1 (“It is expressly agreed that liability for any covered Loss shall attach to the Insurer only after the insurers of the Underlying Policies shall have paid, in the applicable legal currency, the full amount of the Underlying Limit.”) (emphasis added); see also Forest Labs., Inc., 953 N.Y.S.2d at 463 (excess coverage triggers “solely as a result of actual payment of a Covered Claim pursuant to the terms and conditions of the Underlying Insurance thereunder”) (emphasis added).

In addition, the Second Circuit’s decision in Ali v. Federal Insurance Co., 719 F.3d 83 (2d Cir. 2013), has been billed by some as a departure from Zeig. In Ali, former directors of a bankrupt computer technology company sought a declaration that the coverage obligations of their excess insurers were triggered when the total amount of the directors’ defense and/or indemnity obligations exceeded the limits of the underlying insurance policies, regardless of whether the underlying insurance companies had actually paid those amounts. Id. at 87. Two of the underlying insurers were in liquidation and unable to pay claims. The Second Circuit affirmed the district court’s decision, which denied the directors’ motion for summary judgment, and ruled the excess policies did not attach until there was actual payment of the underlying losses. Id. at 94.

The Ali court distinguished Zeig on the grounds that Zeig involved a first-party property policy and the policyholder suffered actual out-of-pocket losses that exceeded the limit of the underlying policy. Ali, in contrast, involved excess liability insurance, and the policyholders’ requested relief focused on their future obligations to pay third parties. The Second Circuit concluded “nothing is inherently errant or
unusual about interpreting an exhaustion clause in an excess *liability* insurance policy differently than a similarly written clause in a first-party *property* insurance policy.” *Id.* at 93.

_Ali_ can be viewed as merely another case employing an overly literal reading of policy exhaustion language that in any event is distinguishable from _Zeig_. And indeed, post-_Ali_ cases across jurisdictions (including New York) have continued to apply _Zeig_ to exhaustion issues and have not limited _Zeig_’s applicability to first-party property cases. *See, e.g., Carrier Corp. and Elliott Co. v. Travelers Indem. Co.*, No. 2005EF7032, at *26 (N.Y. Sup. Ct. Nov. 21, 2018) (“The law is clear in New York that when a policyholder enters into a compromise Settlement Agreement with an underlying insurer for less than its full coverage rights, an excess carrier is obligated to provide coverage so long as the policyholder absorbs the gap between the underlying insurer’s payment and the attachment point of the excess policy.”); *see also Mass. Mut. Life Ins. Co.*, 2014 WL 3707989, at *8. _Ali_ does not require that payments be made by underlying insurers; it simply required, in that case, actual payment (without specifying which party was obligated to make the requisite payment). This distinction has proven important for courts interpreting _Ali_ and applying _Zeig_. For example, the U.S. District Court for the Eastern District of Virginia affirmed _Zeig_’s continued status as a seminal decision on the issue and emphasized that the _Ali_ court “did not state whether the necessary payments had to be made by the underlying insurers.” *See Hopeman Bros., Inc*, 307 F. Supp. 3d at 471-72. The _Hopeman Brothers_ court concluded that although the policy at issue required exhaustion by actual payments, _Ali_ did not support the insurers contention that payments could not be made by the policyholder. *Id.*

**C. A CRITIQUE OF THE COMERICA LINE OF DECISIONS**

Policyholders have criticized the _Comerica_ and _Qualcomm_ line of cases on the ground that the courts’ literalism ignores the important policy rationale of encouraging settlements. That is, if a policyholder jeopardizes its excess coverage by virtue of a less-than-full-limit settlement with its primary policy, it will lose its incentive to settle. Moreover, these decisions fail to give appropriate weight to economic reality. Under the traditional _Zeig_ approach, the excess insurer is not prejudiced because there is no change in the attachment point of the excess policy by virtue of the settlement. Because the
policyholder takes responsibility for the gap between the unexhausted underlying limits and the attachment point of the excess policy, the excess insurer is in no worse position than if the policyholder received full limits from its primary insurer. See Mass. Mut. Life Ins. Co., 2014 WL 3707989, at *8; Mills Ltd. P’ship, 2010 WL 8250837, at *9 (“[E]choing Zeig, there is no business reason offered to explain why it should make a difference to [the excess insurer] if [the policyholder] settled with the underlying carriers, so long as the [excess insurers] policy was going to be reached even if [the policyholder] had collected every cent under its underlying policies.”); Carrier Corp. and Elliott Co., No. 2005EF7032, at *27 (articulating New York’s strong public policy favoring resolution of disputes through settlement and stating that a different ruling would “act as a disincentive for a policyholder to enter into compromise settlements with underlying insurers for less than the full policy as the policyholders would then forfeit an otherwise clear right to access higher level excess policies using an all sums/vertical exhaustion approach”).

The Comerica and Qualcomm line of cases are therefore controversial, and although some courts have followed these rulings, other courts have declined to accept their reasoning. See Mass. Mut. Life Ins. Co., 2014 WL 3707989, at *8; HLTH Corp., 2008 WL 3413327, at *15 (July 31, 2008) (rejecting Comerica and Qualcomm and holding that the law of New Jersey and Pennsylvania follows Zeig and its progeny). But see Intel Corp., 51 A.3d at 449-50 (applying California law).

D. PRACTICAL IMPLICATIONS FOR POLICYHOLDERS

Policyholders and their insurers that wish to finalize a settlement without the risk of jeopardizing the policyholders’ excess insurance first should examine carefully the language of the pertinent excess policies. Excess policies can differ; some contain language like that in Qualcomm with a literal requirement that the underlying policy limits must be exhausted by payments by the underlying insurer; others do not specify that the underlying insurer itself must make the payments and allow for those payments to be made by the policyholder.

The 2018 decision in Hopeman Brothers provides valuable guidance on how courts may examine exhaustion policy language in light of recent Zeig and Comerica/Qualcomm cases. See Hopeman Bros.,
Inc, 307 F. Supp. 3d at 471-72. There, the court reaffirmed that Zeig remains good law and Ali does not prevent policyholders from filling the gap to reach the excess coverage attachment point, but it examined three different exhaustion clauses to determine when a policyholder could credit the difference between a below-limit settlement sum and the attachment point and when it could not. Where a policy provided for attachment only after “the Underlying Umbrella Insurers have paid or have been held liable to pay the full amount of their respective ultimate net loss liability,” the court concluded that the policyholder was precluded from filling the gap. Id. at 474-75 (“[T]his language unambiguously designates the underlying insurer as the party to make any requisite payments.”). But where a policy only stated that the excess insurer would indemnify “for the amount of loss which is in excess of the applicable limits of liability of the underlying insurance” and loss was defined as “the sums paid as damages . . . for which the insured is legally liable,” the policy was ambiguous, Zeig applied, and the policyholder could absorb the difference between the settlement amount and attachment point. Id. at 476 (concluding that the analysis of the Maximus court was most applicable for interpreting this policy). And finally, on the other end of the spectrum, where a policy provides that liability will attach when “the Insured, or the Insured’s underlying insurer, shall have paid the amount of the underlying limits,” the policyholder was clearly permitted to fill the gap. Id. at 477.

If faced with policy language that a court may find to unambiguously require that the underlying insurer pay its full limit as a condition of exhaustion, a policyholder should consider making a prejudice argument. That is, a policyholder can argue that any literal exhaustion condition in the policy should be waived in the absence of prejudice to the insurer. Where a less-than-limit settlement has no effect on the excess policy because the policyholder is filling the gap, the insurer suffers no harm because there is no change to the agreed-upon attachment point of the policy. The insurer is not being required to “drop down” to pay sums below its attachment point or otherwise pay more or pay earlier than what it had bargained to pay. A policyholder can contend that the literal enforcement of an exhaustion requirement under these circumstances would be the equivalent of a forfeiture of coverage. In the context of other policy conditions, such as notice requirements and cooperation provisions, there is ample precedent for
the proposition that a policyholder’s noncompliance with those conditions is excused unless the insurer can prove prejudice. See 22 Georgia Leonhart, Appleman on Insurance Law & Practice § 139.4 (2d ed. 2010). This prejudice standard should provide robust support for a policyholder’s argument in the exhaustion context.

Finally, policyholders may be prudent to include in their policies language that specifically addresses the exhaustion issue. Policyholders and insurers alike have recognized the perverse incentives of the Comerica and Qualcomm holdings in a situation where they have a common interest in settling underlying policies for less than policy limits. Policies now often include “anti-Comerica/Qualcomm” language (by endorsement or as part of the form) intended to avoid the holdings of those cases. For instance, a Directors & Officers policy may state that, “It is expressly agreed that liability for any covered loss shall attach to the insurer only after the insurers of the underlying policies, the insured company and/or the insured persons shall have paid the full amount of the underlying limit for each policy year.” Under this language, either the policyholder or individual insureds can pay for the loss falling within the gap and then proceed to the next excess layer. There are different versions of this type of anti-Comerica/Qualcomm language, and a policyholder purchasing a D&O or other excess policy should ask for this language to be included.