Zig Zag On Zeig: When Is Exhaustion Really Exhaustion

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Law360, New York (November 23, 2015, 12:52 PM ET) -- Excess insurance policies supply coverage above underlying limits provided by primary insurance and "attach," or become liable to pay a covered claim, once the layer(s) of insurance below have been exhausted. This sounds simple enough. However, different courts have reached different opinions as to what constitutes "exhaustion" of a primary policy for purposes of triggering excess coverage. Some courts, absent explicit policy language to the contrary, consider primary coverage exhausted as long as the insured's liability is greater than the primary policy limits. Other courts do not consider a primary policy exhausted unless the primary insurer has paid out its full policy limits to the insured. The result seems to depend in part on whether there is a perceived ambiguity in how the excess policy defines "exhaustion" and in part on the court's approach to the intersection between insurance contract interpretation and public policy concerns. The outcome of a lawsuit over excess policy coverage may depend, not only on the language of the policy itself, but on where the action takes place.

The Zeig Decision
One of the earliest and most influential cases to address this issue was Zeig v. Massachusetts Bonding & Insurance Co.[1] The defendant had issued the plaintiff a $5,000 burglary insurance policy that sat above three other policies with a combined $15,000 in coverage. The excess policy provided that it would "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 plaintiff settled with his underlying insurers for $6,000 and sought coverage from the defendant for amounts above the $15,000 underlying limits. The defendant argued that the plaintiff's below-limits settlement meant that those policies had not been exhausted and that excess coverage did not attach.

The Second Circuit rejected this argument, calling the defendant's "construction of the policy sued on ... unnecessarily stringent."[2] The court acknowledged that "the parties could impose such a condition precedent to liability upon the policy, if they chose to do so."[3] However, here, the excess policy did not explicitly require "'collection' of the full amount of the primary insurance."[4] The Second Circuit interpreted the term "payment of claims" to mean not only cash payment, but also "satisfaction of a claim by compromise or in other ways."[5] Therefore, according to the court, "[t]he claims are paid to the full amount of the policies, if they are settled and discharged, and the primary insurance is thereby exhausted."[6]

The court's principal concern was that, if the defendant's argument were to prevail, it would compromise policyholders' willingness to settle with lower-tier insurers and "involve delay, promote litigation and prevent an adjustment of disputes which is both convenient and commendable."[7] As long as the excess insurer was not being asked provide coverage below the attachment point, the court reasoned that it had "no rational interest in whether the insured collected the full amount of the primary policies."[8] Therefore, the court held that if the plaintiff's loss was greater than the limits of the primary insurance, he was entitled to recover the remainder of his loss to the extent of the excess policy limits.

The question for courts, as framed by Zeig, became whether an excess policy specifically required full limits payments by underlying insurers in order to trigger excess coverage. Of course, the Zeig court did not make clear what type of language would actually generate this "stringent" requirement.

Zeig's Progeny

Initially, it seemed that the Second Circuit's emphasis on public policy concerns would prevail across the country. Other courts followed suit to find that a policyholder who had sustained a loss above primary policy limits but settled with the primary insurer for a lesser amount could still recover on an excess policy.[9] In 1975, the district court for the District of Delaware, citing the public policy considerations underpinning the Zeig decision, asserted that "the reasoning of the Zeig case is correct" and predicted that the Delaware state courts would agree.[10] The Third Circuit affirmed. Some years later, the Third Circuit reiterated its adherence to Zeig in Koppers Co. Inc. v. Aetna Casualty and Surety Co., predicting that the Pennsylvania courts would "adopt the widely-followed rule that the policyholder may recover on the excess policy for a proven loss to the extent it exceeds the primary policy's limits" where the policyholder settles its claim against the primary insurer for less than the policy limits.[11]

While the Pennsylvania appellate courts have yet to verify that they will follow Zeig,[12] the lower Delaware courts at first confirmed, in unpublished opinions, that the Third Circuit's "confidence [that they would adopt Zeig's reasoning] was justified."[13] The Delaware courts were particularly influenced by Zeig's publicly policy considerations. In HLTH Corp. v. Agricultural Excess and Surplus Lines Insurance Co., for example, the Delaware Superior Court echoed Zeig in observing that an excess insurer's liability "is completely unchanged whether plaintiffs have received all of the underlying payments or not" and that "[s]ettlements 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."[14] Similarly, in Mills Limited Partnership v. Liberty Mutual Insurance Co., the Delaware trial court considered it "most important" that "there is no business reason offered to explain why it should make a difference to Liberty Mutual if Mills settled with the underlying carriers, so long as the Liberty Mutual policy was going to be reached even if Mills had collected every cent under its underlying policies."[15]

While the HLTH court — and Zeig-approving courts before it — seemed relatively unconcerned with the wording of the contract in question, in Mills Limited Partnership, the Delaware Superior Court found support for its holding in the policy language itself. There, the excess policy was triggered "when the underlying limit of liability is exhausted by reason of the insurers of the underlying policies paying or being held liable to pay in legal currency the full amount of the underlying limit of liability as loss."[16] The court reasoned that a judicially-approved $190 million settlement of the underlying claim "in effect ... for Zeig's purposes, held the underlying insurers liable to pay the full amount of their liability. That triggered the [excess] insurance policies."[17]

More recently, the Delaware Supreme Court has called the ascendency of Zeig into question. In Intel Corp. v. Amerian Guarantee & Liability Insurance Co., that court, applying California law, found Zeig inapposite and explained that "[p]lain policy language on exhaustion ... will control despite competing public policy concerns," despite the fact that "some courts' decisions, including those of Delaware trial courts, could be read to suggest that [Zeig] requires a different result."[18] While the Delaware Supreme Court did not affirmatively reject Zeig, it did call into question whether Zeig represents the settled law of Delaware. More importantly, it prioritized "unambiguous" policy language over public policy concerns.

Focus on Policy Language

Courts deviating from Zeig, like the Delaware Supreme Court in Intel, tend to emphasize insurance policy language over matters of public policy. For example, in Comerica Inc. v. Zurich American Insurance Co., the Eastern District of Michigan, applying Michigan law, held that excess policy language requiring "actual payment of loss ... by the applicable [primary] insurers" unambiguously necessitated that the policyholder receive actual payment of the total policy limits by the primary insurer in order to trigger excess coverage.[19] In so holding, the court distinguished the Zeig line of cases, noting that courts following Zeig "generally rely on an ambiguity in the definition of 'exhaustion' or lack of specificity in the excess contract as to how the primary insurance is to be discharged."[20] Perhaps in reaction to this observation, the Mills Limited Partnership court was careful to invoke policy language, rather than public policy alone, in support of its holding.

Similarly, in Citigroup Inc. v. Federal Insurance Co., the Fifth Circuit, applying Texas law, held that the plain language of the four excess policies at issue "dictate[d] that the primary insurer pays the full amount of its limits of liability before excess coverage is triggered."[21] The court examined the wording of each of the policies in reaching its conclusion. The excess policies variously required that the primary insurer pay the "full," "total" or "all" limits of liability before the primary policies were to be considered exhausted. The Fifth Circuit found that this phrasing required payment by the underlying insurer of the full policy limits in order to trigger excess coverage. The court also cited the Comerica decision in finding that the phrase "payment of loss" required actual payment of losses by the underlying insurer, as opposed to a credit against a judgment or a settlement that extinguished liability.[22]

Other courts across the country have followed similar reasoning. For example, in Qualcomm Inc. v. Certain Underwriters at Lloyd's, London, which the Delaware Supreme Court cited in Intel, the California Court of Appeals examined an excess policy that provided for coverage "'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.'"[23] The court held that the policy "cannot have any other reasonable meaning than actual payment of no less than the $20 million underlying limit" was required to trigger excess liability.[24] The court also noted that there was no evidence that the primary insurer had accepted responsibility or liability for the full amount of the $20 million limit on the underlying policy, such that the "held liable to pay" language could not give rise to coverage as it had in Mills Limited Partnership.

In Forest Laboratories Inc. v. Arch Insurance Co., the New York Supreme Court, applying New York law to language it determined to be unambiguous, declined to decide whether the Zeig rule applied in New York state courts.[25] There, the excess policy required "'actual payment of a covered claim pursuant to the terms and conditions of the underlying insurance thereunder.'"[26] Unlike in Citigroup or Qualcomm, the excess policy apparently did not specify that the policyholder had to pay the "full" or "total" limits in order to trigger excess coverage. However, the court held that because the "terms and conditions" of the underlying insurance policies included their term limits, the excess policy attached only "after the underlying insurers pay up to their policy limits." Id. The Appellate Division affirmed, stating that "the express terms of [the] policy providing excess coverage to the plaintiff required the previous layer of excess coverage to be exhausted through actual payment of that policy's limit prior to [the excess insurer] being required to pay."[27]

While the critical question to a court considering the Zeig rule is whether or not a policy's exhaustion requirement is ambiguous or vague, some courts are simply more willing to find ambiguity — or a lack of specificity — than others. In Maximus Inc. v. Twin City Fire Insurance Co., for example, the excess policy

provided coverage "only after all applicable underlying insurance ... has been exhausted by actual payment under such underlying insurance."[28] While the Citigroup panel might have cited the "all ... underlying insurance" and "actual payment" language to bar recovery against the excess insurer, the Eastern District of Virginia determined that the excess policy did not require "payment of the *full limit* of an underlying policy by the lower-tier carriers" or explicitly preclude the insured from filling the gap to exhaust the primary policy.[29] In the absence of highly specific instructions as to primary policy exhaustion, the court sided with the policyholder against the insurer to allow coverage.

Conclusion

The outcome of a dispute over primary policy exhaustion turns on some combination of the policy language at issue and the public policy concerns associated with penalizing a policyholder for settling with its insurers. The relative weight given to each of these factors seems to vary between jurisdictions, or even within a single jurisdiction depending on the circumstances of a given matter. Industry professionals should be aware of the consequences of policy wording that is unclear — or even arguably vague — with respect to primary policy exhaustion and the potential advantages of one jurisdiction over another depending upon the phrasing of the policy at issue.

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[1] 23 F.2d 665 (2d Cir. 1928).

[2] Id. at 666.

[3] Id.

[4] Id.

[5] Id.

[6] Id.

[7] Id.

[8] Id.

[9] See, e.g., Handleman v. U.S. Fidelity & Guaranty Co., 18 S.W.3d 532, 534 (Mo. App. Ct. 1929); Benroth v. Continental Casualty Co., 132 F.Supp. 270, 277 (W.D. La. 1955); and more recently, Lasorte v. Those Certain Underwriters at Lloyd's Severally Subscribing to Policy Numbers 115NAP108111970 And 115NAP109111970, 995 F.Supp.2d 1134 (D. Montana, 2014) (applying New York law to find that, where the term "exhaustion" was not specifically defined, it was ambiguous, and exhaustion could be achieved via settlement).

[10] Stargatt v. Fidelity & Casualty Co. of New York, 67 F.R.D. 689 (D. Del. 1975), aff'd, Stargatt v. Fidelity & Casualty Co. of New York, 578 F.2d 1375 (3rd Cir. 1978).

[11] 98 F.3d 1440, 1454 (3rd Cir. 1996).

[12] See Lexington Insurance Co. v. Charter Oak Fire Insurance Co., 81 A.3d 903, 909 (Pa. Super. Ct. 2013) ("No Pennsylvania appellate court has addressed when an exhaustion clause triggers an excess insurer's duty to defend.")

[13] Mills Ltd. Partnership v. Liberty Mutual Insurance Co., (Del. Sup. Ct. Nov. 5, 2010); see also HLTH Corp. v. Agricultural Excess and Surplus Insurance Co. (Del. Sup. Ct. July 31, 2008).

[14] HLTH Corp. v. Agricultural Excess and Surplus Insurance Co.

[15] Mills Ltd. Partnership v. Liberty Mutual Insurance Co.

[16] Id., at *2.

[17] Id., at *9.

[18] 51 A.3d 442, 450 (Del. 2012).

[19] 498 F.Supp.2d 1019, 1032 (E.D. Mich. 2007).

[20] Id. at 1030.

[21] 649 F.3d 367, 372 (5th Cir. 2011).

[22] Id. However, in Plantation Pipe Line Co. v. Highlands Insurance Co., 444 S.W.3d 307 (Tex. Ct. App. 2014), the Texas Court of Appeals, carefully parsing the language in an excess policy, distinguished Citigroup to find that the unambiguous language in the policy before the court permitted it to be triggered where the policyholder had settled with underlying insurers for less than the policy limits. As the court explained, "we see nothing [in the excess policy language] that requires payment of losses solely by the insurers up to the attachment amount." 444 S.W.3d at 313. Because the insurers and policyholder, combined, paid a sum greater than the attachment point of the excess policy, the policyholder was entitled to excess coverage.

[23] 161 Cal.App.4th 184, 195 (Cal. Ct. App. 2008). See also Quellos Group LLC v. Federal Insurance Co., 177 Wash. App. 620 (Wash. Ct. App. 2013), applying Washington law to similar language to hold that the excess policies required the underlying insurer to pay the full limits of liability before the excess policy was triggered.

[24] Id.

[25] 38 Misc.3d 260, 267 (N.Y. Sup. 2012). Other jurisdictions, however, clearly believe Zeig is the rule in New York: per Lasorte v. Those Certain Underwriters at Lloyd's Severally Subscribing to Policy Numbers 115NAP108111970 and 115NAP109111970, 995 F.Supp.2d 1134, 1143 (D. Montana 2014), for instance, "[t]he court's reasoning in Zeig remains good law in New York."

[26] 38 Misc.3d at 267.

[27] Forest Laboratories Inc. v. Arch Insurance Co., 116 A.D.3d 628 (N.Y.A.D. 2014).

[28] 856 F.Supp.2d 797, 799 (E.D. Virginia, 2012).

[29] Id. at 801.

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