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***Are You Really Exhausted? Negotiating Settlements  
for Less than Policy Limits - Recent Trends and  
Decisions***

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**I. INTRODUCTION**

Issues relating to excess insurance are often at the forefront of twenty-first century insurance claims and/or underwriting disputes. In years past, excess insurance was generally reserved for the truly catastrophic type of loss. However, the onslaught of large class actions, mass torts litigation, large financial and banking losses and other large-scale litigation has exponentially increased the potential significance of even the highest layer excess insurance policies. Moreover, as limits of liability on older primary commercial general liability (CGL) policies have been depleted in responding to these massive claims, insureds are increasingly looking to their excess insurers as a means of reducing their exposure. Not surprisingly, in light of the relatively small premiums that were paid by policyholders for this excess coverage as opposed to the large amount of exposure at stake, excess insurers are more willing than ever to challenge claims. These coverage disputes have generated a number of complex issues as to how a multi-layer insurance tower functions in response to large dollar claims.

At the center of many of these disputes is whether there has been proper exhaustion of the limits of liability that underlie the excess insurers' policies. Notwithstanding that the concept of "exhaustion" is fundamental to a multi-layered coverage program, how and under what circumstances the underlying insurance will be found to be exhausted—thereby triggering the excess insurer's obligations—is replete with complicated issues. Some of the questions that commonly arise in this context are:

- Does the underlying insurance have to have actually "paid" the claims to be exhausted?
- Will exhaustion be "deemed" to have occurred under certain circumstances, even where there has not been actual payment or the underlying claims have not been completely resolved?
- Can an excess insurer be bound by a settlement between the primary insurer and the policyholder in which the primary coverage is declared by the parties to be "exhausted"?
- Is the fact that the total amount of the claims for which the insured may be liable exceeds the attachment point of the excess insurer's policies sufficient to constitute exhaustion?
- How do issues of exhaustion impact an insurers' duty to defend?
- How do reinsurers view the impact of a settlement?

These and other questions have spawned a plethora of litigation concerning the meaning of the concept of exhaustion. For nearly eight decades, courts throughout the United States have pondered over the interpretation of conditions in excess policies that require complete exhaustion of underlying insurance. While some courts enforced excess policies as written and held that exhaustion requires actual payments by the underlying insurers, other courts—following the

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seminal decision in *Zeig v. Massachusetts Bonding & Ins. Co.*, 23 F2d 663 (2d Cir. 1928) – declined to enforce such provisions, citing public policy that encourages settlement of claims, and have thus held that primary insurance layers can be exhausted by less than limits settlements with the insured.

The *Zeig* reasoning has been used by numerous state and federal courts for decades to justify the requirement that excess insurers pay claims notwithstanding the failure to exhaust underlying policies through actual payments as required by the contract. More recently, however, there have been a series of rulings across the country that have rejected the rationale of *Zeig* in favor of application of contract certainty as set forth in: *Qualcomm, Inc. v. Certain Underwriters at Lloyd's, London*, 161 Cal. App. 4th 184 (Cal. App. 4th Dist. 2008); *Intel Corp. v. American Guarantee & Liability Insurance Co.*, 2012 Del. LEXIS 480, Case No. 692, 2011 (September 7, 2012); and *JP Morgan Chase & Co. v. Indian Harbor Ins. Co.*, 2012 N.Y. App. Div. LEXIS 4627 (N.Y. App. Div. June 12, 2012.)

United States courts analyzing coverage disputes arising out of below-limits settlements are scrutinizing the specific language requirements in excess policies regarding the manner in which underlying policies will be considered exhausted so as to trigger an excess policy. Accordingly, excess insurers should carefully note the trends in the law, and particular policy language that may influence whether their insureds can claim exhaustion of underlying policies without actually receiving payment of the full underlying limits.

This paper will first provide a discussion on the general principles that are fundamental to an understanding of the concept of underlying exhaustion, and summarize the divergent approaches taken by courts in the United States when addressing the issue of what constitutes underlying exhaustion in determining whether excess coverage will be available to an insured. In recent years there has been a shift in the tide on this issue which now appears to strongly favor excess insurers. Courts are refusing to read the once bedrock case of *Zeig* as standing for the proposition that a below limits settlement of an underlying policy with the insured, “fills the gap” and automatically exhausts the underlying policy. Rather, the trend of recent cases has been to hold that below-limits settlements coupled with gap filling by insureds is insufficient to trigger coverage under excess policies. Finally, this paper also addresses the industry’s response to these changes from both the perspective of the insurer and the broker.

Given the unsettled landscape of the law on this issue, insurers and reinsurers of multi-layered insurance programs need to be prepared to address the issue of underlying exhaustion when presented with a claim that has the potential to reach excess layers of coverage, such that they can conclusively answer the question “Are you really exhausted?”

**II. PRINCIPLES OF UNDERLYING EXHAUSTION**

Generally speaking, excess insurance is triggered or “attaches” only after a predetermined amount of applicable underlying insurance -- *i.e.*, the layer below -- is exhausted. *Schulman Investment Co. v. Olin Corp.*, 514 F. Supp. 572, 576 (S.D.N.Y. 1981); *Wells Fargo Bank v. California Ins. Guar. Assn.*, 38 Cal. App. 4<sup>th</sup> 936, 940 (1<sup>st</sup> Dist. 1995); Couch on Insurance 2d, p.62.91 (“Excess insurance does not come into operation until the damage exceeds the maximum limitation of the primary policy.”). An excess insurer is “the secondary insurer on the scene.” *Schulman, supra*, 514 F. Supp. at 576; *Sherwin-Williams Co. v. Insurance Co. of Pennsylvania*, 105 F.3d 258, 259 (6th Cir. 1997) (also referring to excess coverage as “secondary” insurance). Put another way, the exhaustion of primary insurance is a condition precedent to an excess insurer’s obligation to pay. *See, Comerica Inc. v. Zurich Am. Ins. Co.*, 498 F. Supp.2d 1019, 1028 (E.D. Mich. 2007); *Aeroflot-General Corp. v. Commercial Union Ins. Co.*, 155 Cal. App. 4<sup>th</sup> 132, 137 (3d App. Dist. 2007) (equating the attachment of liability clause to a condition precedent).

As a condition precedent to coverage, the next question is who has the burden of establishing that there has been exhaustion of underlying insurance. Several courts have indicated that the insured has the burden of establishing that underlying insurance has been exhausted in order to trigger excess coverage. *See, e.g., Consolidated Edison Co. of New York v. Fyn Paint & Lacquer Co., Inc.*, 2005 U.S. Dist. LEXIS 899 at \*16 (E.D.N.Y. 2005) (holding that an excess insurer’s duty to defend is triggered “only when there is a showing that ‘the potential liability of the insured is so great’ that the primary insurers’ coverage will be exhausted.”); *Sherwin-Williams Co., supra*, 105 F.3d at 263 (6th Cir. 1997) (holding that the insured “must first show that there is no other insurance coverage available to it beyond mere denial by [the primary insurer].”) This approach makes sense because clearly the insured generally is in a better position than the excess insurer to know if and when underlying primary insurance has been exhausted.

One issue that arises in this context is whether the primary limits must actually be paid in order to be considered “exhausted.” In certain instances, courts have held that the excess insurer has the burden of demonstrating that an insured’s settlement with the primary insurer had a value of less than the primary limits such that the policy is not exhausted. *Stargatt v. The Fidelity & Casualty Co. of New York*, 67 F.R.D. 689, *aff’d* without opinion, 578 F.2d 1375 (3d Cir. 1975).

In *Stargatt*, the insured securities brokerage firm had multiple insurance policies in place to protect it against claims for liability under federal and state securities laws. *Stargatt, supra*, 67 F.R.D. at 690. The primary policy, issued by The Fidelity & Casualty Company of New York (“Fidelity”), contained a limit of \$250,000; the excess policy, issued by Lloyd’s of London (“Lloyd’s”), provided coverage of \$750,000. According to its terms, the excess policy applied “only when the Primary Policy...has been exhausted.” *Id.* The insured’s receiver brought a declaratory judgment action against Fidelity and Lloyd’s alleging that the insured had sustained covered losses in excess of \$4.5 million. Both insurers denied coverage and Fidelity asserted a counterclaim seeking reimbursement of \$650,000. The receiver settled its claim against Fidelity for \$135,000 and the release of Fidelity’s counterclaim. Thereafter, Lloyd’s moved for summary judgment on the ground that because the limits of the Fidelity policy were not exhausted by the

settlement, the Lloyd's excess policy could not be triggered. *Id.* The court denied Lloyd's motion because "it [was] not clear that the consideration received by [the insured] for claims under the [Fidelity] policy had a value of less than \$250,000." *Id.* at FN 2. Still, the court held that the insured, *vis a vis* its receiver, had the burden of proving the amount of its losses and the extent to which such losses were covered. *Id.* at 691.

In the seminal case of *Zeig*, discussed in detail below, the subject excess policy required that the underlying policy be exhausted but was silent about whether the full amount of the underlying policy needed to actually be paid before the excess policy would be triggered. The *Zeig* Court's decision does not explain why the underlying policy was not collected, but the Court held that the policy was exhausted by discharge under the settlement and that the excess policy therefore was implicated. *Zeig*, 23 F.2d at 666. The *Zeig* Court concluded that the excess insurer was not prejudiced because the insurer "was only called upon to pay such portion of the loss as was in excess of the limits of [the underlying insurance]." *Id.*

However, a number of recent rulings have challenged the approach taken by the *Zeig* Court and have looked to the specific policy language to determine whether an excess policy has been implicated. Understanding the developing split in jurisdictions between the adherence to the earlier holding in *Zeig* as compared to a more modern approach that looks to the policy language, has proved to be an important and emerging area of insurance law that directly impacts excess insurers.

### **III. TWO DIVERGENT APPROACHES: ZEIG VS. COMERICA/ QUALCOMM**

#### **A. The *Zeig* Rule**

A majority of jurisdictions throughout the United States follow the rule that a settlement between an insured and an underlying insurer for less than policy limits does not prevent the insured from seeking coverage from its excess insurers. Instead, the insured is treated as self-insured for any gap between the settlement amount and the underlying policy limits, and any damages in excess of the underlying policy limits are borne by the excess insurers to the extent they are covered by the excess policies.

This rule was first articulated by the Second Circuit Court of Appeals on 9 January 1928 in *Zeig v. Massachusetts Bonding & Insurance Company*, 23 F.2d 665 (2nd Cir. 1928).<sup>1</sup> In *Zeig*, the Second Circuit rejected the argument that an excess insurance policy is triggered only if the insured actually collects the full amount of the underlying policy limits from the underlying insurer. In so holding, the court reasoned that "[t]o 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." *Id.* at 666. Therefore, "[t]he plaintiff should [be] allowed to prove the amount of his loss, and if that loss [is]

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<sup>1</sup> The Second Circuit Court of Appeals has jurisdiction over the states of New York, Connecticut and Vermont. Accordingly, *Zeig* is generally followed in New York.

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greater than the amount of the expressed limits of the primary insurance, he [is] entitled to recover the excess to the extent of the policy in suit.” *Id.*

In *Zeig*, the insured incurred losses covered by policies in excess of \$15,000 and settled the first three insurance policies for \$6,000; \$9,000 less than the combined policy limits. Massachusetts Bonding refused to cover *Zeig*’s damages in excess of \$15,000, arguing that “it was necessary for the plaintiff actually to collect the full amount of the policies for \$15,000, in order to ‘exhaust’ that insurance.” *Id.* at 666. On appeal, the Second Circuit Court of Appeals rejected the insurers’ argument that an excess insurance policy is triggered only if the insured actually collects the full amount of the underlying policy limits from the underlying insurer, and held that:

Such a construction of the policy sued on seems unnecessarily stringent. It is doubtless true that the parties could impose such a condition precedent to liability upon the policy, if they chose to do so. But the defendant 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. To require an absolute collection of the primary insurance to its full limits 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.

*Id.* The *Zeig* Court therefore concluded that the excess policy at issue did not require that the underlying policies be exhausted by actual payment by the underlying insurers, and held that “[t]here is no need of interpreting the word ‘payment’ as only relating to payment in cash. It often is used as meaning the satisfaction of a claim by compromise, or in other ways.” *Id.*

Allowing an insured to be treated as self-insured for a gap between a settlement amount and an insurer’s policy limits has been adopted in a majority of United States jurisdictions. *See, e.g., Federal Ins. Co. v. Srivastava*, 2 F.3d 98 (5th Cir. 1993); *Stargatt v. Fidelity & Cas. Co. of New York*, 67 F.R.D. 689 (D. Del. 1975), *aff’d*, 578 F.2d 1375 (3d Cir. 1978); *Siligato v. Welch*, 607 F. Supp. 743 (D. Conn. 1985); *Reliance Ins. Co. v. Transamerica Ins. Co.*, 826 So. 2d 998 (Fla. Ct. App. 2001). Although the *Zeig* Court did not construe the excess policy as requiring actual payment of the underlying limits, it is clear from the above-quoted language and the cases that have followed *Zeig* that the primary motivation behind the court’s ruling was the strong public policy argument favoring settlements.

### **B. The Comerica/Qualcomm Rule**

Although the *Zeig* rule is followed in a majority of states, a minority of jurisdictions have diverged from the Second Circuit’s reasoning. *See Ostrager & Newman* §13.04. These jurisdictions reject *Zeig*’s public policy reasoning and instead focus on the policy language at

issue. Under this analysis a minority of courts have more recently held that the express language of an excess policy requires actual payment by the underlying insurer before the policy is exhausted such that excess coverage may be triggered. These courts often support their holdings by citing to the *Zeig* Court's statement that "[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." *Zeig*, 23 F.2d at 666.

**1. *Comerica Inc. v. Zurich American Insurance Company***

One of the leading cases to adopt the minority rule is *Comerica Inc. v. Zurich American Insurance Company*, 498 F. Supp.2d 1019 E.D. Mich. 2007). On 17 July 2002, Comerica issued a press release announcing financial results for the second quarter 2002. Comerica then announced on 2 October 2002 that the 17 July press release had been incorrect. Five securities class action lawsuits ensued, which were eventually settled by Comerica for \$21 million. At the time of the settlement, Comerica had incurred a total of \$2.6 million in defense costs.

Comerica had purchased a \$20 million primary insurance policy from Federal Insurance Company ("Federal") covering the period at issue in the securities class actions. Comerica had also purchased a \$20 million excess insurance policy from Zurich American Insurance Company ("Zurich"). Comerica sought coverage under the two policies, which both Federal and Zurich disputed. On 30 December 2004, Comerica and Federal settled their coverage dispute, agreeing that Federal would pay \$14 million towards the settlement of the underlying litigation. They also agreed that "the policy [Federal] shall be deemed fully exhausted and is null and void and has no force or effect whatsoever." *Comerica*, 498 F. Supp.2d at 1025-26.

After settling with Federal, Comerica sought \$1 million plus costs of defense (\$2.6 million) from the Zurich excess policy. Zurich refused coverage, and argued that the Federal policy was not exhausted by actual payments. Comerica filed suit against Zurich, and Zurich moved for summary judgment, arguing that it was not obligated to pay because Federal did not actually pay the full \$20 million primary policy limits. *Id.* at 1026.

The Zurich policy provided that:

In the event of the depletion of the limit(s) of liability of the "Underlying Insurance" solely as a result of actual payment of loss thereunder by the applicable insurers, this Policy shall . . . continue to apply to loss as excess over the amount of insurance remaining . . . In the event of the exhaustion of the limit(s) of liability of such "Underlying Insurance" solely as a result of payment of loss thereunder, the remaining limits available under this Policy shall . . . continue for subsequent loss as primary insurance . . . .

This Policy only provides coverage excess of the "Underlying Insurance." This 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



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by reason of the reduction or exhaustion of the available “Underlying Insurance” through payments of loss thereunder . . . .

*Id.* at 1022 (alterations in original). Comerica opposed Zurich’s motion, arguing, among other points, that public policy supported its argument that Zurich pay any amount in excess of the \$20 million underlying limits.

The court granted Zurich’s motion for summary judgment. Relying on Michigan law, it first rejected the analysis adopted in *Zeig*, stating that “[t]he cases that follow *Zeig* generally rely on an ambiguity in the definition of ‘exhaustion’ or lack of specificity in the excess contracts as to how the primary insurance is to be discharged.” *Id.* at 1030. The Comerica Court instead concluded that “[a] different result occurs when the policy language is more specific”. Citing to the language of the Zurich policy the Comerica Court went on to note:

Payments by the insured to fill the gap, settlements that extinguish liability up to the primary insurer’s limits, and agreements to give the excess insurer “credit” against a judgment or settlement up to the primary insurer’s liability limit are not the same as actual payment. 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 reasons of the reduction or exhaustion of the available ‘Underlying Insurance’ through payments of loss thereunder.” That never happened in this case.

*Id.* at 1032.

Finally, the Comerica Court cited with favor to the *Zeig* Court’s statement that “[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.” *Id.* (quoting *Zeig*, 23 F.2d at 666). Following from that statement, the *Comerica* Court held, “[t]he contract language here states that is exactly what the parties did, and Comerica’s argument to the contrary would require a contract rewrite, which this Court is not inclined to do.” *Id.*

The Comerica Court thus rejected the insured’s public policy argument, and instead enforced the clear and unambiguous terms of the insurance policy at issue. The court stated that Comerica chose to settle its dispute with Federal, accepting a less than policy limits settlement in order to avoid the possibility of losing all of its coverage at trial. *Id.* In seeking coverage from Zurich, “Comerica seeks the certainty that its settlement brought and the benefit of coverage from its excess carrier as if it has won its dispute with the primary insurer, despite language in the excess policy to the contrary.” *Id.* The Comerica Court thus held that the policy language controlled and, because the primary insurer had not actually paid its full limits, the primary policy was not exhausted such that there was no coverage under the excess policy.

2. *Qualcomm, Inc. v. Certain Underwriters at Lloyd's London*

On 25 March 2008, the California Court of Appeals for the Fourth Appellate District rejected the reasoning of *Zeig*, when it concluded that acceptance by an insured in settlement of less than primary policy limits precludes the insured's ability to recover from its excess insurers. See *Qualcomm, Inc. v. Certain Underwriters at Lloyd's, London*, 161 Cal. App. 4th 184 (Cal. Ct. App. 2008), *review denied*, 2008 Cal. LEXIS 6969 (Cal. Jun. 11, 2008).

Qualcomm purchased a D&O policy from National Union Fire Insurance Company of Pittsburgh, P.A. ("National Union") with policy limits of \$20 million for the policy period of 15 March 1999 to 15 March 2000. Qualcomm also obtained a first layer excess "following form" policy from Certain Underwriters at Lloyd's, London ("Underwriters") that attached excess of the National Union primary policy.

In May 1999, Qualcomm employees filed a class action lawsuit against Qualcomm relating to asserted rights to unvested company stock options. Additional employees filed separate lawsuits against Qualcomm seeking acceleration of stock option vesting. After protracted litigation, Qualcomm settled the lawsuits. At the time of the settlement it had incurred defense and settlement costs of approximately \$30 million. Qualcomm sought coverage under the National Union and Underwriters' policies. Both insurers disputed coverage. Eventually, National Union settled with Qualcomm for \$16 million. Thereafter, Qualcomm sought \$10 million in coverage under the Underwriters' policy with the understanding that it would absorb the \$4 million difference between the settlement payment by National Union and the National Union policy limits. Underwriters denied coverage, arguing that the excess policy had not been triggered because National Union had not "paid" its \$20 million policy limits as required under the language of the excess contract. Qualcomm sued Underwriters for breach of contract and declaratory relief, arguing that:

when an insured settle[s] with its primary insurer for an amount below the primary policy limits but absorbs the resulting gap between the settlement amount and the primary policy limit, primary coverage should be deemed exhausted and excess coverage triggered, obligating the excess insurer to provide coverage under its policy.

*Id.* at 188.

Qualcomm further argued that allowing it to absorb the difference between the amount paid by the primary insurer and the limit of the underlying policy would not put Underwriters in any worse position than if National Union had actually paid its full policy limit. Additionally, Qualcomm contended that denying coverage under the facts presented would violate public policy by providing a windfall to the excess carrier, and discourage settlements between insureds and their primary insurers. The trial court disagreed, and held that Underwriters' policy was not triggered. Qualcomm appealed.

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The Court of Appeals affirmed the trial court's decision, and held that the unambiguous language of Underwriters' policy required National Union to pay the \$20 million policy limits and did not allow Qualcomm to fund the \$4 million gap created by its less than limits settlement. The court began its analysis by discussing the principles of insurance policy interpretation, under which "a court must give effect to the mutual intention of the parties when they formed the contract", which is primarily controlled by the "clear and explicit" terms of the contract. *Id.*

Underwriters' policy stated that "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." *Id.* at 195. The Qualcomm Court thus concluded that the clear and explicit meaning of "the phrase 'have paid . . . the full amount of [\$20 million],' when read in the context of the entire excess policy, cannot have any other reasonable meaning than actual payment of no less than the \$20 million underlying limit." *Id.* (alterations in original).

In reaching its decision, the Qualcomm Court was not swayed by the strong public policy arguments articulated in *Zeig*. In fact, the Fourth Appellate District specifically refused to follow the holding in *Zeig*, stating:

First, 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. Second, we disagree with its strained interpretation of the word "payment." Third, the *Zeig* court acknowledged that parties in these circumstances may include excess policy language explicitly requiring actual payment as a condition precedent to coverage and that a court may reach a contrary result "when the terms of the contract demand it." The exhaustion clause here compels us to conclude that the parties expressly agreed that National [Union] was required to pay (or be legally obligated to pay) no less than \$20 million as a condition of Underwriters' liability.

*Id.* at 197-98 (citations omitted). The court similarly rejected other non-California authorities adopting *Zeig*'s reasoning because "most of these decisions have as a 'common thread' the [public] policy rationale favoring the efficient settlement of disputes between insurers and insureds, a rationale that in our view cannot supersede plain and unambiguous [insurance] policy language." *Id.* at 199 (citations omitted).

As in *Comerica*, the *Qualcomm* Court looked beyond the public policy arguments adopted by *Zeig* and its progeny, and chose instead to enforce the unambiguous terms of the insurance contract. Based on these terms, Qualcomm was entitled to coverage under the excess policy only after the underlying insurer had actually paid the full limits of the primary policy. Absent, such actual payment, the excess insurer was not obligated to provide coverage to the insured.<sup>2</sup>

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<sup>2</sup> Also, see *Danbeck v. American Family Mutual Insurance Company*, 629 N.W.2d 150 (Wis. 2001) where the Wisconsin Supreme Court held that the policy language required actual payment of the full policy limits stating:

#### IV. RECENT JUDICIAL DECISIONS

A number of recent rulings across the United States have rejected the rationale of *Zeig* in favor of the contract certainty analysis discussed above. These courts reject the *Zeig* rule, choosing instead to enforce the terms of the excess policies as written, thereby denying coverage when an insured enters into a below underlying limits settlement. Two cases in particular have received significant attention by insurance coverage practitioners and courts presented with this issue: *Intel Corp. v. American Guar. and Liability Ins. Co.*, and *JPMorgan Chase & Co. v. Indian Harbor Ins. Co.*.

##### **A. *Intel Corp. v. American Guar. and Liability Ins. Co.***

In *Intel Corp. v. American Guarantee & Liability Insurance Co.*, 2012 Del. LEXIS 480, Case No. 692, 2011 (September 7, 2012), litigation arose out of claims by Intel against defendant, American Guarantee & Liability Insurance Co. (“AGLI”) for defense and indemnity for antitrust suits filed against Intel by its competitor Advanced Micro Devices, Inc. (“AMD”) in connection with its sale of microprocessors. AGLI had issued a Following Form Excess Policy that did not, by its terms, contain a defense obligation. However, by endorsement, the AGLI Policy provided that it followed form to the defense obligation contained in the underlying policy issued by XL Insurance Co., which obligation was limited by providing that there was no duty to defend until the XL policy was exhausted by “payment of judgments or settlements.” Intel sought coverage from AGLI for the AMD claims, asserting that the claims were within the personal and advertising injury coverage grant of the XL Policy to which AGLI followed form, and further contended that the XL Policy had been exhausted by settlement for less than limits.

The claims resulted in parallel declaratory judgment actions, the first filed by AGLI in Delaware Superior Court naming Intel and other insurers, and the second filed by Intel in the United States District Court for the Northern District of California naming AGLI alone. Although AGLI contested Intel’s claim that the AMD suits fell within the Personal and Advertising Injury coverage grant of the AGLI Policy, the threshold issue in both actions was whether Intel’s settlement with XL Insurance Company for less than XL’s policy limits exhausted the XL Policy for purposes of triggering the AGLI Policy. By opinion dated 29 July 2010, the Delaware Superior Court granted summary judgment to AGLI finding no exhaustion of the underlying policy. Similarly, by opinion dated 6 December 2010, the United States District Court for the Northern District of California granted summary judgment in favor of AGLI finding no exhaustion of the underlying XL policy. Intel appealed both summary judgment rulings. Both appeals were fully briefed, but the appeal before the Delaware Supreme Court was argued and decided before the Ninth Circuit scheduled oral argument.

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“while the “settlement plus credit” approach to exhaustion has the same practical effect as payment of full policy limits, it is not consistent with the plain language of the policy, which unambiguously requires exhaustion “by payment of judgments [sic] or settlements,” not settlement plus credit.” The Court in *Danbeck* also rejected the argument that the public policy of fostering settlements should control the resolution of the case.

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On appeal, AGLI argued to the Delaware Supreme Court on appeal that the conditions for exhaustion of the XL Policy for purposes of Intel's defense cost claims were governed by Endorsement 1, which created a defense obligation by providing that AGLI would follow form to the defense obligation contained in the XL Policy. This endorsement provided that the defense obligation would not arise until the underlying XL Policy was exhausted by payment of judgments or settlements, a term which, under governing California law required full payment of policy limits. Intel, on the other hand, argued that exhaustion was governed by Condition H in the excess policy form which provided that exhaustion could occur by a combination of payments by Intel and an underlying insurer.

On 7 September 2012, the Delaware Supreme Court, unanimously affirmed the Opinion of the Delaware Superior Court Judge, granting summary judgment in favor of AGLI and against Intel, holding that Intel's settlement with AGLI's underlying insurer for less than policy limits did not constitute exhaustion. The Delaware Supreme Court held that, viewing the policy as a whole, "Intel's reading is untenable," and that only AGLI's reading of the policy properly reconciled the language contained in the policies. The Court held that under California law, the phrase "payments of judgments or settlements" cannot be expanded to include an insured's own payment of defense costs. In so holding, the Court looked to the California Appellate Court decision in *Qualcomm* as informative to its interpretation of the AGLI policy and specifically stated that the holding in *Zeig* was inapplicable, as the plain language of the policy, as interpreted by AGLI, controls. The Delaware Supreme Court further held that Intel's "strained" interpretation of the policy language, in an attempt to read a defense obligation into Condition H of the AGLI Policy, was irrelevant to the duty to defend and would create an irreconcilable conflict within the policy terms. Instead, the Court held that AGLI had proffered the only reasonable interpretation of the policy language in arguing that exhaustion of the underlying XL policy by "payments of judgments or settlements," does not include Intel's own contributed payments for defense costs and therefore AGLI did not have an obligation to provide reimbursement for defense costs.

The Court also rejected Intel's contention that reasonable expectations would compel adoption of its position, and found that it was not objectively reasonable to expect that AGLI's excess coverage would be triggered only after the underlying policy is exhausted by indemnity payments and not defense costs. Following issuance of the Delaware Supreme Court Opinion, Intel voluntarily dismissed its pending appeal in the Ninth Circuit Court of Appeals.

### ***B. JPMorgan Chase & Co. v. Indian Harbor Ins. Co.***

On 11 February 2013, the highest court of New York State denied the application of JPMorgan Chase ("JPMC") for leave to appeal an appellate ruling in favor of insurers, in an insurance coverage declaratory judgment action styled, *JP Morgan Chase & Co. v. Indian Harbor Ins. Co.*, 2012 N.Y. App. Div. LEXIS 4627, 2012 NY Slip Op 4702 (1<sup>st</sup> Dep't June 12, 2012). The 12 June 2012 appellate ruling, decided under Illinois law, affirmed the dismissal of approximately \$95 million in claimed Bankers Professional Liability and Securities Claim coverage for underlying suits filed against Bank One.

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The coverage dispute involved over \$175 million in insurance under primary and excess policies issued to Bank One in 2002. The underlying suits sought damages based on JPMC's role as indenture trustee and for certain notes issued by affiliates of National Century Financial Enterprises, Inc., a now defunct entity that was alleged to have run a ponzi scheme involving securitization of medical accounts receivables. JPMC settled the underlying lawsuits for \$178 million then sought coverage under Bank One's Bankers Professional Liability and Securities Claim policies.

JPMC sued all the insurers in the 2002 tower of insurance. Shortly thereafter it settled with the third and eighth excess insurers, for \$17 million which settlement resolved coverage claims under the 2002 insurance policy for the Bank One claims, as well as for an earlier policy. However, JPMC failed to allocate the settlement between two different insurance towers. As a result, JPMC was unable to demonstrate the amount, if any, the underlying third excess insurer paid in settlement of the Bank One claim. Although the specific language in each of the insurers' excess policies varied slightly, each required that the underlying policy limits be paid by the underlying insurers before the excess policy would be triggered.

Defendant Twin City Fire Insurance Company, a fourth excess insurer, joined by the excess insurers above it, moved to dismiss the coverage action against it on the basis that its policy contained a condition precedent requiring it to pay losses only after each insurer beneath it both admitted liability for the losses and paid the full amount of its liability under its policy. JPMC argued that the full limits of the insurers' coverage were owed to indemnify it for covered losses, to which Twin City responded that because JPMC's settlement with the third excess insurer did not allocate the \$17 million settlement between the two policies, JPMC was unable to prove that the third excess policy was exhausted.

The New York Supreme Court granted the excess insurers' motions for summary judgment. The court found the excess insurance provisions at issue to be unambiguous, upheld the underlying exhaustion provisions as written, and held the excess policies were not triggered because the full underlying policy limits had not been paid by the settling insurers. The court held that absent JPMC's ability to demonstrate that the underlying insurance had been fully exhausted, liability did not attach. The court, therefore, dismissed the claims against the excess insurers.

On appeal, the New York Appellate Division, First Department, unanimously affirmed the Supreme Court's grant of summary judgment and held that, although worded slightly differently, each of the policies "unambiguously required the insured to collect the full limits of the underlying policies before resorting to excess insurance." The Appellate Division agreed with the position advanced by the excess insurers that settlement for less than the underlying insurer's limits of liability does not exhaust the underlying policy. Under this reasoning, the Appellate Division affirmed the entry of summary judgment. The New York Court of Appeals denied JPMC's motion for leave to appeal this ruling.

**C. Other Notable Cases.**

Over the last few years, a number of courts in other jurisdictions have issued rulings that touch on, and further interpret, the *Comerica/Qualcomm* rule, including: *Trinity Homes LLC v. Ohio Cas. Ins. Co.*, 2009 WL 3163108 (S.D. Ind. Sep. 25, 2009); *Schmitz v. Great Am. Assurance Co.*, 2010 WL 2160748 (Mo. Ct. App. Jun. 1, 2010); *Great Am. Ins. Co. v. Bally Total Fitness Holding Corp.*, 2010 WL 2542191 (N.D. Ill. Jun. 22, 2010); and most recently *Mehdi Ali, et al. v. Federal Insurance Company, et al.*, Docket No. 11-5000-cv, No. 11-5000 (2d Cir. June 4, 2013).

In *Trinity Homes LLC*, the court held that, “[p]ursuant to the clear terms of [the insurance policy], the availability of an underlying policy turns on whether the applicable limits of that underlying policy have been exhausted, or merely reduced by payment of claims.” 2009 WL 3163108, at \*11. Based on a narrow interpretation of the language of the excess policy, the *Trinity* Court held that only actual payment by the underlying insurer was sufficient to exhaust the excess policy, leaving open the possibility of a different result if presented with different policy language. *Id.* at \*12.

Similarly, in *Schmitz*, the court held that an excess insurer’s obligation applies only after the underlying policy is “exhausted solely by payment of those specified amounts of money actually paid in settlement or satisfaction of a claim.” 2010 WL 2160748, at \*4. In that case, the settlement agreement between the insured and the primary insurers was for less than primary policy limits and, therefore, the primary policy limits were not “actually paid.” Again, influenced exclusively by the policy language at issue, the *Schmitz* court held that the excess insurer was not responsible for providing coverage.

In *Bally Total Fitness*, the court noted the differences between those courts applying *Zeig* and those courts following *Comerica/Qualcomm* as follows:

If an excess insurance policy ambiguously defines exhaustion, as in *Zeig*, courts generally find that settlement with an underlying insurer exhausts the underlying policies. However, in cases when the policy language clearly defines exhaustion, the courts tend to enforce the policy as written. Even the Second Circuit in *Zeig* noted that parties are free to clearly define how an underlying policy must be exhausted and can preclude settlement as a method of exhaustion.

2010 2542191, at \*4 (internal citations omitted).

**1. *Mehdi Ali, et al. v. Federal Insurance Company, et al.***

Most recently, on 4 June 2013, the United States Court of Appeals for the Second Circuit (the Court that decided *Zeig*) ruled that several excess directors and officers (D&O) insurance policies were not triggered until there had been payment of losses amounting to the attachment point of each excess policy. In *Mehdi Ali, et al. v. Federal Insurance Company, et al.*, Docket

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No. 11-5000-cv, No. 11-5000 (2d Cir. 4 June 2013) the Second Circuit held that the applicable excess coverage is not triggered when the underlying liability *obligations* reach the attachment point, but instead when actual “liability *payments* reach the attachment point.” The court interpreted several excess D&O liability insurance policies which provided that coverage was triggered when the underlying insurance is exhausted “as a result of payment of losses thereunder.”

In *Mehdi Ali*, the former D&Os of bankrupt Commodore International Limited were insured by a \$50 million tower of insurance consisting of a primary D&O policy and eight excess policies. Insurers of four of the excess policies, including the excess policy attaching directly above the primary policy, were insolvent and unable to pay losses. The former directors sought a declaration that the excess insurers’ coverage obligations: “are triggered once the total amount of defense and/or indemnity *obligations* exceeds the limits of any insurance policies underlying their respective policies, regardless of whether such amounts have actually been paid by those underlying insurance companies.” The lower court denied the directors’ motion for partial summary judgment and held that the applicable excess policy language provided that the underlying insurance must be exhausted “solely as a result of payment of losses thereunder” which is not triggered by the aggregation of the directors’ covered losses.

On the Second Circuit Court of Appeals addressed the issue of policy interpretation and exhaustion. The policies at issue contained language that triggered the excess coverage only after the exhaustion of underlying insurance “solely as a result of payment of losses thereunder.” The Second Circuit held that the directors’ “obligations” for payment are not synonymous with actual “payments” of those obligations as required under the policies. The Second Circuit thus concurred with the trial court that the express policy language established a “clear condition precedent to the attachment of the excess policies” which requires actual payments up to the respective attachment points before the excess policies are triggered.

Significantly, the Second Circuit rejected the directors’ reliance on *Zeig* which had been decided by it in 1928. Instead, the Second Circuit found that *Zeig* was distinguishable because exhaustion language should be interpreted differently in an excess liability insurance policy as opposed to a first-party property policy such as that at issue in *Zeig*. The Court stated “the excess insurers here had good reason to require actual payment up to the attachment points of the relevant policies.” The Second Circuit determined that the excess insurers’ policies included specific language intended to deter the possibility of settlement manipulation, and under a belief, confirmed by the Second Circuit, that the plain meaning of the phrase “payment of losses” refers to the actual payment of losses suffered by the directors and not the mere accrual of losses in the form of liability obligations. The *Mehdi Ali* decision may foreshadow a new approach to the rationale of *Zeig* in the future.

### **2. *Maximus, Inc. v. Twin City Fire Insurance Company***

The United States District Court for the Eastern District of Virginia, in *Maximus, Inc. v. Twin City Fire Insurance Company*, 856 F. Supp. 2d 797, 798 (E.D. Va. 2012), ruled that ambiguous language appearing in a third-layer excess professional liability policy issued by Axis Reinsurance Company (“Axis”) permitted Maximus, Inc. (“Maximus”) to exhaust the policy



limits of all policies below Axis by: (1) settling its coverage claims with each underlying insurer, and (2) “filling the gap” by paying the difference between what each underlying insurer paid and the insurer’s policy limit. Under this holding, Maximus may call on Axis and claim “functional exhaustion” of the underlying layer(s).

Maximus was involved in an underlying breach of contract lawsuit arising from its provision of health and human services programs in the State of Texas. Maximus claimed coverage for total damages of \$78.3 million based on an underlying settlement agreement. Addressing Maximus’ coverage claim to Axis for damages in the \$60 to \$70 million range, the court found that Maximus had satisfied the Axis policy’s underlying exhaustion requirement. Applying Virginia law, the *Maximus* court held that the Axis policy’s exhaustion provision was ambiguous and instead relied on the “public policy favoring settlements” as articulated in *Zeig*. According to the *Maximus* court, *Zeig* concluded that it made no practical difference to an excess insurer whether its exhaustion point was reached by full collection of the underlying policy limits, so long as the excess insurer was only called upon to pay the portion of loss in excess of the underlying limits. The *Maximus* court further cited to *Zeig* when it stated that litigation, delay, and other inconvenience contrary to public policy would result from inhibiting settlements between underlying insurers and policyholders. *Id.* at 801.

As can be learned from the discussion above, depending on the jurisdiction, a court’s determination of underlying exhaustion related to settlements for less than primary limits remains uncertain.

## **V. THE INDUSTRY’S RESPONSE TO THE ZEIG VS. QUALCOMM DILEMMA**

In the following section we address the insurance industry’s response to these recent decisions from both the perspective of the insurer, as well as the insurance broker on behalf of a prospective policyholder.

### **A. How Can An Excess Insurer Avoid A *Zeig* Result?**

As discussed above, it is evident that courts analyzing coverage in the context of below-limits settlements are scrutinizing the specific language requirements in excess policies regarding the manner in which underlying policies will be considered exhausted so as to trigger an excess policy. Excess insurers should carefully monitor the trends in the law, and be familiar with the particular policy language that may influence whether a policyholder can claim exhaustion of underlying policies without actually receiving payment of the full underlying limits.

In light of these recent rulings some insurers 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. Some of this language, as illustrated below, can be found in the insuring grant of an excess policy:

...If underlying insurance does not pay a “loss” for reasons other than the exhaustion of an aggregate limit of insurance, then we will not pay such “loss”.

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[ACE Catastrophic Liability Plus Policy XSC-27266 (May 2009)]

...If any underlying insurance does not pay damages, for reasons other than exhaustion of an aggregate limit of insurance, then we shall not pay such damages.”

[Firemans Fund 5503 10 02R]

These examples express the insurer’s intent to only pay damages under its policy upon exhaustion of underlying insurance by payment by the underlying insurer. Moreover, the language leaves no suggestion that the insurer intends for payments by the insured or any other party to fill the gap in order to access the next layer of coverage.

In addition to modifications in the insuring grant, consideration needs to be given to the language in the exhaustion provision. Some examples of language that United States courts have found to be unambiguous, and have therefore ruled in favor of insurers are as follows:

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.

[*Qualcomm, infra*]

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 and the Insureds shall have paid the full amount of the uninsured retention, if any, applicable to the primary Underlying Policy.

[*Bally Total Fitness, infra*]

The Underwriters’ liability to pay under this Policy shall attach only when the Underlying Insurer(s) shall have paid or have been held liable to pay, the full amount of the Underlying Limit(s) shown in Item 6 of the Schedule.

[*JPMC, infra*]

United States courts have found that the clauses cited above demonstrate that the excess insurer requires payment in full by the underlying insurer before liability attaches.

It is therefore important for an excess insurer to ensure that its policy language explicitly and unequivocally expresses its intent that the full amount of the underlying policy(ies) need to be collected or actually paid before the excess policy is triggered. As demonstrated above,

leaving any ambiguity in the insurance contract may expose the insurer to significant risk by allowing an insurer to access layers of excess coverage without full exhaustion of underlying policy limits.

**B. Brokers' Response To Circumvent The Requirement Of Full Exhaustion Of Underlying Limits**

Insurance brokers, on the other hand, are looking for ways to circumvent the requirement that full underlying limits be exhausted prior to triggering excess layers. In an effort to avoid the *Comerical/Qualcomm* rule, policyholders are beginning to request inclusion of endorsements to umbrella and excess policies that are specifically drafted to allow the insureds to enter into less than policy limits settlements with underlying insurers. The courts that follow the *Comerical/Qualcomm* rule do so by focusing exclusively on policy language to determine the trigger of the excess coverage. It is therefore, reasonable that these same courts will allow less than limits payment by an underlying insurer, if such intent is clearly bargained for and reflected in an endorsement that expressly allows such partial payments.

Another trend among brokers is to attempt to negotiate "Shaved Limits", "Limits Shaving" or "Limits Reduction" endorsements. These endorsements, which were normally only seen in multi-layered D&O policies, may be gaining momentum with multi-layer CGL programs. In essence, the endorsement requires the follow form excess insurer to respond whenever a covered loss payment reaches its layer regardless of *who* pays the underlying amounts. These "Shaved Limits" endorsements expressly recognize the insured's right, consistent with the ruling in *Zeig*, to trigger excess coverage through payment of the underlying limits by the primary carrier and/or the insured.

**VI. CONCLUSION**

While there has been a shift by courts away from strictly following *Zeig* for the proposition that the gap left by a below limits settlement of an underlying policy with the insured can be filled by an insured and create functional exhaustion of an underlying policy, nationwide case law still remains unsettled. Vital to the understanding of this developing distinction is that courts analyzing coverage in the context of below-limits settlements are scrutinizing more closely than ever, the specific language requirements in excess policies regarding the manner in which underlying policies will be considered exhausted so as to trigger an excess policy. Therefore, it is even more important for excess insurers to carefully note the trends in the law, and particular policy language, which may potentially influence whether their policyholders can exhaust underlying policies without actually receiving payment of the full underlying limits.

Given the unsettled landscape of the law on this issue, insurers in multi-layered insurance programs need to be prepared to both determine a uniform litigation strategy when presented with claims that potentially may reach its layer of coverage; and on a going forward basis, consider the implications of policy language that specifies that excess coverage is not triggered in the absence of actual payments of full underlying limits.