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Commentary

Below-Limits Settlements Do Not Result In The Loss Of Excess Coverage – *Zeig* Remains Guiding Precedent, Even Post-*Ali*

By
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Excess insurance policies typically include provisions stating that the policyholder cannot pursue coverage from the excess insurer until the policyholder has received payment from the underlying insurers. One of the most frequently-litigated questions in excess insurance law is whether such provisions bar the policyholder from entering into a below-limits settlement with an underlying insurer. Put differently: Suppose a policyholder holds a $20 million primary insurance policy and a $10 million excess insurance policy, and incurs a $25 million loss for which it seeks coverage. Suppose further that the policyholder files a claim with the primary insurer and settles with that insurer for $15 million. May the policyholder file a claim with the excess carrier for the $5 million loss exceeding the excess policy's $20 million attachment point? Or does the below-limits settlement with the underlying insurer operate as a complete waiver of the excess insurance policy?

In the leading case on this issue, *Zeig v. Massachusetts Bonding and Ins. Co.*, 23 F.2d 665 (2d Cir. 1928) (A. Hand, J.), the Second Circuit concluded that a below-limits settlement with an underlying carrier did *not* result in a waiver of excess coverage. The excess insurance policy in *Zeig* required that the primary insurance be "exhausted in the payment of claims to the full amount of the expressed limits." *Id.* at 666 (quotation marks omitted). The court concluded that this requirement was satisfied by a below-limits settlement with an underlying insurer, reasoning: "There 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. To render the policy in suit applicable, claims had to be and were satisfied and paid to the full limit of the primary policies." *Id.* The court cited two practical justifications for its decision. First, "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." *Id.* Second, "[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.*

More recent cases on this issue have reached divergent conclusions. The majority of cases have followed *Zeig*. *See, e.g.*, *Maximus, Inc. v. Twin City Fire Insurance Co.*, 856 F. Supp. 2d 797 (E.D. Va. 2012); *Trinity Homes LLC v. Ohio Casualty Insurance Co.*, 629 F.3d 653 (7th Cir. 2010). But a few courts have rejected *Zeig*, holding that a below-limits settlement with an underlying insurer results in a complete waiver of excess coverage. *See, e.g.*, *Citigroup, Inc. v. Fed. Ins. Co.*, 649 F.3d 367 (5th Cir. 2011); *Comerica Inc. v. Zurich Am. Ins. Co.*, 498 F. Supp. 2d 1019, 1022 (E.D. Mich. 2007). In light of this divergence of authority, and the ubiquity of below-limits settlements with underlying insurers, the continued vitality of *Zeig* has become a central issue in numerous excess insurance disputes.

Recently, in *Ali v. Federal Ins. Co.*, 719 F.3d 83 (2d Cir. 2013), the Second Circuit analyzed its decision in *Zeig* for the first time in 85 years. And although the outcome of the case represented a victory for the insurer, the court's reasoning reaffirms the principle first announced in *Zeig*: that a policyholder can enter into a below-limits settlement with an insurer without waiving excess coverage. The court's decision is, therefore, a significant victory for policyholders in excess insurance disputes and a confirmation of the continuing applicability of the *Zeig* principle.

In *Ali*, the policyholders had purchased a primary liability insurance policy and a tower of eight excess policies, and two of the insurers in the tower had gone bankrupt. Two other, still-solvent excess insurers in the tower had issued excess policies, which required the policyholders to exhaust the underlying policies by "payment of losses thereunder." The policyholders sued these excess insurers, seeking a declaration that their "coverage obligations are triggered once the total amount of [the policyholders'] 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." 719 F.3d at 87 (emphasis in original). To put the policyholder's position in concrete terms: one of the excess policies at issue covered liability in excess of $40 million, with a $10 million limit of liability. The policyholders sought a declaration that, if they incurred a $50 million judgment or settlement, the excess insurer would then be required to pay its policy limit of $10 million – even if *neither* the underlying insurance companies *nor* the policyholders paid a penny of the underlying $40 million obligation.

The Second Circuit rejected the policyholder's position. The court concluded that the plain text of the policies supported the insurers, reasoning that " 'obligations are not synonymous with 'payments' on those obligations. To hold otherwise would make the 'payment of' language in these excess liability contracts superfluous. . . . Because the plain language of the contracts specifies that the coverage obligation is not triggered until *payments* reach the respective attachment points, the District Court properly denied the Directors' request for a declaration that coverage obligations are triggered once the Directors' defense and indemnity *obligations* reach the relevant attachment point." *Id.* at 91.

Ali was a simple case – the policyholders' position had neither textual nor pragmatic arguments with which to support their coverage-promoting outcome. As the court observed, the policyholders' position was directly contrary to the text of the policies, which required *payment* of losses under the underlying policies. And neither of the two pragmatic justifications of *Zeig* applied. The *Zeig* court noted that the insurer in that case had no rational interest in barring policyholders from entering into below-limits settlements and paying up to the excess insurance policy floor out of pocket. But in *Ali*, requiring actual payment by *someone* was necessary to "deter[] the possibility of settlement manipulation" – specifically, the possibility that the policyholders "might be tempted to structure inflated settlements . . . that would have the same effect as requiring the Excess Insurers to drop down and assume coverage in place of the insolvent carriers." *Id.* at 94. And *Zeig* observed that there is a policy interest in encouraging policyholders to enter into below-limits settlements with underlying insurers. In *Ali*, of course, there were no below-limits settlements with underlying insurers, and, thus, that policy interest does not apply.

But the more important part of *Ali* was its analysis of the more frequently-litigated question of whether a below-limits settlement with an underlying insurer results in a waiver or forfeiture of excess coverage. On this question, the Second Circuit came out squarely on the side of policyholders. The Second Circuit endorsed the District Court's ruling that "the underlying *insurers* [need not] make payments before the obligations under the relevant excess policies are triggered. Rather, . . . the exhaustion requirement [is written] in the passive voice and did not specify which party was obligated to make the requisite payments." *Id.* at 92. This is exactly what *policyholders* argue in cases involving below-limits settlements with underlying insurers: if payment is made *either* by the underlying insurer, *or* by the policyholder, up to the attachment point of the excess policy, then the insurer is obligated to pay any loss exceeding the excess policy.

In its analysis of *Zeig*, the court reached the same conclusion. It observed that *Zeig* and its progeny "principally address situations in which a policy was deemed exhausted as a result of an insured's below-limit settlement of indemnity claims with an underlying carrier." *Id.* at 93. It explained: "In those cases [following *Zeig*], the insured suffered out-of-pocket losses (for instance, through the loss of property, or through liability payments to a third party) for which the insured sought indemnification. The Directors" requested relief, by contrast, focuses on their *obligations* to pay third parties. In these circumstances, . . . this difference is relevant when structuring (and interpreting) a liability insurance policy." *Id.* This analysis is a clear endorsement of *Zeig* in the context of below-limits settlements with underlying insurers – and a clear repudiation of cases such as *Comerica* and *Citigroup*, which held that such settlements acted as a waiver of excess coverage.

Insurers may point to dictum in a recent Pennsylvania Superior Court case, *Lexington Ins. Co. v. Charter Oak Fire Ins. Co.*, No. 2876 EDA 2012, 2013 WL 5935237 (Pa. Super. Nov. 6, 2013), as evidence that *Ali* may have undermined *Zeig*. But *Lexington* is entirely consistent with *Zeig*. In *Lexington*, an underlying insurer entered into a settlement agreement with the policyholder under which the settlement amount would reach the underlying insurer's policy limits upon payment, but there was a two-month delay between the settlement agreement and the physical payment of the settlement amount. *Id.* at *4. The Superior Court held that the duty to *defend* did not arise until the payment of the settlement amount occurred. *Id.* at *5. *Lexington* involved *neither* an insurer's duty to indemnify, *nor* a below-limits settlement, and is thus doubly irrelevant to the dispute addressed in *Zeig*.

In dictum, the court also added:

> [W]e agree with recent precedent from the Second Circuit distinguishing *Zeig*. In *Ali v. Fed. Ins. Co.*, 719 F.3d 83, 94 (2d Cir.2013), the Second Circuit concluded that an excess insurer does have a relevant interest in awaiting actual payment of a settlement by the primary insurer. According to the Second Circuit, excess insurers "had good reason" to dissuade insureds from "structur[ing] inflated settlements with their adversaries . . . that would have the same effect as requiring [excess insurers] to drop down and assume coverage [prematurely]."

Id. Notably, when the Court referred to "actual payment of a settlement by the primary insurer," it was distinguishing the situation in which the primary insurer signs a settlement agreement, but does not send any money – which was the situation in *Lexington*. The Court did not cast doubt on the propriety of below-limits settlements in which the underlying insurer *does* pay an agreed-upon amount to the policyholder, the policyholder absorbs the remainder of the underlying insurer's policy layer out of pocket, and the policyholder then seeks coverage from the excess insurer for its remaining loss. In that situation, *Zeig*, *Ali*, and *Lexington* all support the proposition that coverage is available from the excess insurer.

Ali is a very significant case. Eighty-five years after *Zeig*, the Second Circuit has made clear that *Zeig* is still good law in the Second Circuit, and that policyholders may enter into below-limits settlements with underlying insurers without waiving or forfeiting excess coverage in such a way that would result in a windfall to the excess insurer. Although *Ali* found the policyholders' request for coverage under those circumstances to be unsupported, its reaffirmation of *Zeig* is likely to be considerably more influential.

Endnote

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