WHAT DOES IT MEAN TO "EXHAUST" AN UNDERLYING LAYER OF INSURANCE?

By

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I. Introduction

Many insurance professional might read literally a requirement that the underlying layer of insurance must be exhausted (or words to that effect) by payment of claims before the excess insurer has any liability. However, literal readings of policy language has a spotty history before the courts, *see e.g.* cases dealing with the "absolute" pollution endorsement. A court's recent resolution of a reinsurance dispute in *Lexington Ins. Co. v. Tokio Marine & Nichido Fire Ins.,* No. 11-cv-00391, (S.D.N.Y March 28, 2012), and the line of cases it represents, suggest alternative meanings with respect to exhaustion of an underlying layer. The purpose of the article is to examine selected case law dealing with the two lines of cases on the meaning of exhaustion of an underlying layer.

II. Cases with a Literal Reading of "Exhausted"

The excess insurer provided $1 million in limits excess of $100,000 in *United States Fire Ins. Co. v. Lay*, 1978 U.S. App. Lexis (7th Cir.). The insured was responsible for an auto accident and reached a pre-hearing settlement with the primary and the plaintiff to the effect that all recoveries would come from insurance proceeds and that the primary's responsibility would be discharged by a $70,000 contribution to the settlement. When a $150,000 jury verdict resulted, the excess declined to pay. The excess policy stated: "Liability of the company with respect to any one occurrence shall not attach unless and until the insured, the company on behalf of the insured, or the insured's underlying insurer, has paid the amount of the retained loss." *Id.* at *6. The court found for the excess insurer on the basis the settlement removed any liability of the insured. In responding to the line of case described in §III, *infra*, the court stated:

> We can conceive of good reasons for an excess carrier to be unwilling to accept liability unless the amount of the primary policy has actually been paid. A settlement for less than the primary limit that imposed liability on the excess carrier would remove the incentive of the primary insurer to defend in good faith or to discharge its duty to represent the interests of the excess carrier. (citation omitted) *Id*. at *7.

The excess insurer provided $20 million in coverage over a $20 million primary layer in *Comerica Inc. v. Zurich American Ins. Co.,* 498 F. Supp.2d 1019 (ED Mich. 2007). The insured negotiated a $21 million settlement of security fraud claims and then negotiated a settlement of a coverage action with the primary insurer for $14 million, absorbing the remaining $6 million of that layer. The insured sought to recover $1 million in damages plus legal fees from the excess insurer pursuant to an excess policy, which stated:

> In the event of the depletion of the limit(s) 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 . . . . *Id.* at 1022.

The *Comerica* court again rejected the line of cases described in §III, *infra*, as applicable to disputes involving less specific policy language and found for the excess insurer stating:

> The Court believes that the excess policy in this case likewise requires that the primary insurance be exhausted or depleted by the actual payment of losses by the underlying insurer. 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 . . . . *Id.* at 1032.

Great American Ins. Co. v. Bally Total Fitness Holding Corp., 2010 U.S. Dist. Lexis 61553 (ND IL.) was a directors and officers coverage suit in a matter in which the

insureds allegedly had incurred damages which reached at least the third excess layer. The insurers on the first two layers settled for less than their limits and were released from further liability. The insurers on the third and fourth layers refused to pay on the basis that the underlying insurance was not exhausted "solely as a result of actual payment of loss or losses thereunder . . . ." *Id.* at *8, as was required by policy language. Distinguishing a line of cases dealing with policy language that is less explicit (*see* §III, *infra*), the court ruled for the excess insurer:

> [T]he Third Layer Excess Policy's plain language is not ambiguous regarding the manner in which the underlying insurance policies must be exhausted. Thus, this Court, in accordance with well-established Illinois law, must enforce the plain language as written. [citation omitted] *Id.* at *17.

Wright v. Mission Ins. Co., 598 F. Supp. 1178 (W.D. Mo. 1984) involved an excess policy that stated that it could be called upon to pay a loss "only after the Primary and Underlying Excess Insurers have paid or have been held liable to pay the full amount of Primary and Underlying Excess limits." *Id.* at 1187-8. Pursuant to this language, the court found that the excess insurer, Mission, had no obligation to pay a loss until the underlying insurers paid or were held liable to pay their shares of the loss. The court commented:

> [S]ince the underlying insurers have a duty "to defend in good faith . . . . [and] to represent the interests of the excess carrier," to ignore the policy provisions in question would effectively deprive Mission of a material benefit for which it implicitly bargained when it undertook the risk of excess coverage. (internal citations omitted). *Id.* at 1197.

Coverage litigation with the underlying insurer resulted in a settlement for less than limits and a release of the underlying insurer in *Qualcomm Inc. v. Certain Underwriters at Lloyd's, London,* 161 Cal. App. 4th 184 (2008). The excess policy in question contained the following language: "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 189. The court ruled for the excess insurer, noting that it was not persuaded by what it characterized as the public policy considerations at the base of the contrary line of cases (*see* §III, *infra*):

> Our interpretation of the excess policy compels us to conclude that Underwriter's coverage obligation did not arise because Qualcomm's

> pleadings establish the primary insurer neither paid the 'full amount' of its liability limit nor had it become legally obligated to pay the full amount of the primary liability limit in the parties' settlement agreement. *Id.* at 188.

See also Intel Corp. v. American Guarantee & Liability Co., 2012 Del. Lexis 480 following *Qualcomm* under California law with respect to a duty to defend provision.

But see Stonewall Ins. Co. v. Superior Court, 2010 Cal. App. Unpub. Lexis 8625 in which another panel of the California Court of Appeals declined to follow *Qualcomm* with respect to a horizontal settlement of mass tort claims involving many policies and policy periods.

III. Cases with a More Nuanced Reading of "Exhausted"

The line of case distinguished and criticized in the cases above began with *Zeig v. Massachusetts Bonding & Ins. Co.*, 1928 U.S. App. Lexis 3225 (2nd Cir.). The opinion is very brief but it is evident that the excess policy required that the underlying be "exhausted by the payment of claims to the full amount of the express limits." *Id.* at *2. It can be inferred that the underlying cover was compromised for less than its limits but that the total loss claimed exceeded the attachment point of the excess cover. Writing for the court, Augustus Hand acknowledged that a policy could be constructed that made actual payment of the underlying limits a condition precedent but saw no benefit to such a reading on a public policy basis:

> [The excess insurer] has 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 limit would in many, if not most, cases involve delay, promote litigation, and prevent and 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.* at *1

With respect to the contractual requirement of exhaustion by "payment" on the policy at issue, Judge Hand interpreted that as any means by which the primary's limit was expended:

> The claims are paid to the full amount of the policies, if they are settled and discharged, and the primary insurance is thereby exhausted. There is no need of interpreting the word "payment" as only relating to payment in cash. It is often 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.* at *2.

So saying, the Second Circuit ruled that underlying layer had been exhausted and the excess layer was at risk, should the claimant be able to prove that the total amount of the loss penetrated the excess layer.

The ruling in *Zeig* was followed in *Perira v. National Union Fire Ins. Co.*, 2006 U.S. Dist. Lexis 49263 (S.D.N.Y) in which the excess policy stated that it would respond to clams "[i]n the event of the depletion of the limits of liability of the Underlying Insurance solely as the result of actual payment of claims or losses thereunder by the applicable insurers . . . ." *Id.* at *24. The underlying insurer was unable to pay claims due to its insolvency. In ruling for the claimant, the court held:

> Interpreting the policy to excuse the excess insurers from providing coverage within their respective layers on account of the unrelated insolvency of an intermediary insurer would work a similar hardship on the insureds, who have already been deprived of a layer of coverage by the insolvency, and provide a windfall to the excess insurers. *Id.* at *26.

The *Zeig* ruling was followed most recently in the Second Circuit in *Lexington Ins. Co. v. Tokio Marine & Nichido Fire Ins.,* No. 11-cv-00391 (S.D.N.Y. March 28, 2012). This case involved a reinsurer of the two excess layers of coverage on the World Trade Center loss. The excess and primary insurers settled a coverage dispute over the number of occurrences and spread the settlement proportionately among the primary and excess layers, which resulted in payments, which were less than the respective limits. The reinsurer argued that it was not liable to indemnify the excess insurer as the primary limits had not been exhausted. The court ruled for the excess insurer stating:

> So long as the total loss exceeds the attachment point of the excess policy, the law in this Circuit does not require exhaustion of the primary insurance policy to trigger the excess insurer's obligations, regardless of what settlement the primary insurer may have reached.

> . . . . In the absence of unambiguous language requiring exhaustion via full payment of the underlying policy, no such exhaustion is required. *Slip op.* at 8-9.

The seventh circuit ruled similarly in *Trinity Homes LLC v. Ohio Casualty Ins. Co.*, 629 F.3d 653 (7th Cir. 2010). The umbrella policy stated: "If the limits of the 'underlying insurance' have been exhausted by payment of claims, this policy will continue in force as 'underlying insurance.'" *Id.* at 658. Several of the underlying insurers settled a claim with the insured absorbing the difference between such settlements and the underling limits. The court ruled for the insured holding:

> The umbrella policy is clear only insofar as it requires that the underlying CGL coverage be unavailable – either by exhaustion or denial of coverage – before [the umbrella's] coverage is triggered. While the umbrella agreement does not state that a CGL policy is exhausted when the policy limit has been completely expended, it does not clearly provide that the full limit must be paid out by the CGL insurer alone. As such, the policy is ambiguous and susceptible to the meaning put forth by [the insured] . . . . *Id.* at 658.

Courts in other circuits have followed *Zeig*, or its reasoning, in cases involving similar facts and excess policy language. *Chemical Leaman Tank Lines v. Aetna Assurance Co.*, 177 F.3d 210, 227-8 (3rd Cir. 1999); *Maximus Inc. v. Twin City Fire Ins. Co.*, 2012 U.S. Dist. Lexis 32970 (E.D. Va); *Continental Ins. Co. v. Northern Indiana Public Service Co.*, 2011 U.S. Dist. Lexis 37095 (N.D. Ind.); *Lightfoot v. Hartford Fire Ins. Co.*, 2011 U.S. Lexis Dist. (E.D. La); *Elliott Co. v. Liberty Mutual Ins. Co.,* 434 F. Supp.2d 483 (N.D. Ohio 2006); *Stargatt v. Fidelity and Casualty Co. of N.Y.,* 1975 U.S. Dist. Lexis 11413 (D. Del.) *aff'd* 578 F.2d 1375 (3rd Cir. 1978).

IV. Commentary

Both the "literal reading" and "nuanced reading" lines of cases acknowledge that excess policies should be interpreted in accordance with their terms and it would be convenient to distinguish the cases on this basis. (*See* the excess drop down cases of the 1980's *but see* cases on the interpretation of the "absolute" pollution endorsement.) However, a reading of the excess policy language in both lines of cases reveals little difference.

Perhaps the "nuanced reading" cases can be better explained by: (1) the litigation practicalities of resolving settlement disputes; (2) the promotion of settlements; and (3) the avoidance of forfeiture of an insured's excess insurance.