Fine Print Online
August 2014

Excess Exhaustion

by Robert M. Horkovich and Robert Y. Chung

Insurance companies are having some success in court discouraging settlements—no matter how reasonable—between policyholders and lower-layer insurance companies. They are doing this by fighting access to excess insurance coverage unless the primary or lower-level policies have paid 100% of their liability. Some courts have ruled that if a lower-layer policy is settled for anything less than 100% of its policy limits, it never can be exhausted, and accordingly, liability never can attach to the excess policies lying above it. Another unfortunate example recently came to pass in New York state.

In Forest Laboratories, Inc. v. Arch Insurance Co., the New York Appellate Division, First Department, unanimously affirmed the trial court's decision to allow an excess insurance company to avoid coverage merely because the policyholder settled an underlying policy for less than 100% of policy limits, despite the fact that the policyholder made up the difference. In that case, the defense and partial settlement of an underlying securities fraud case was covered and partially paid for by the primary directors and officer liability insurance policy, as well as four other policies excess of the primary. Three additional insurance companies with policies in the uppermost excess layers denied coverage despite the acknowledgment of coverage by the underlying insurance companies. Ultimately, the policyholder settled for partial policy limits with all but the uppermost layer and "filled in the gaps" to ensure "actual payment" of the two settled underlying policies' limits.

The Appellate Division affirmed the trial court's decision with minimal analysis. An examination of the trial court's ruling, however, limits the breadth of the appellate decision. The trial court's decision held that where a policyholder settles with an underlying insurance company for less than full limits, even if a policyholder "filled in the gaps", underlying policies are not exhausted if the policy language requires that "insurers of the underlying policies shall have paid in legal currency the full amount of the underlying limit for such policy period."

Policyholders should be aware of this danger. These decisions permit excess insurance companies to overreach and contradict the basic ruling laid out in the majority Zeig rule. In that seminal 1928 United States Court of Appeals case, Zeig v. Mass. Bonding & Ins. Co., Judge August Hand held that an excess insurance company must pay if its layer of coverage has been pierced by sufficient liability, even if the policyholder has settled with its underlying insurance company for less than the underlying policy's limits and made up the difference.

In laying out its decision in Forest Laboratories, the trial court acknowledged the Zeig rule but declined to apply it due to the specific "incorporation" language at issue in that case. The actual policy language at issue merely required "actual payment of a covered claim pursuant to the terms and conditions of the underlying insurance thereunder." According to the trial court, that language alone lacked "clarity" and would have subjected it to the Zeig rule, if not for the incorporation of the "terms and conditions of the underlying insurance thereunder." The ultimate language relied upon in the decision was due to the incorporation of the hyper-specific wording found in the underlying policies. Thus, any court applying New York law should continue to apply the Zeig rule even where "actual payment" is required and confine any application of the Forrest Laboratories decision to instances where policy

language is identical to the specific policy language addressed therein.

In any event, policyholders should resist any attempt by insurance companies to flout the Zeig rule. Otherwise, policyholders with excess coverage will be discouraged from entering into settlements with primary or lower-level insurance companies and be forced into scorched earth litigation strategy in every insurance coverage controversy.

Decisions contrary to the Zeig rule ignore practical realities and allow an excess insurance company to avoid payment of covered claims at the level at which they agreed to insure such claims, based upon circumstances irrelevant to its own insuring obligations.

Policyholders considering settling lower-level policies where excess policies are implicated at a minimum need to consider the following:

- Prior to purchasing a policy, attempt to eliminate language stating that the underlying coverage has to be paid or be held liable to pay their limits, before the excess insurance attaches.
- When pursuing coverage in one of the minority jurisdictions not following Zeig, consider a top-down settlement strategy—settle with the higher level excess insurance companies before the underlying companies.
- If excess insurance companies refuse to settle, consider legal proceedings against underlying insurance companies, holding them liable before settling with excess insurance companies. While this additional litigation is a costly result of a few short-sighted anti-Zeig decisions, it may be less expensive than forfeiting excess insurance coverage. ■

Robert M. Horkovich *is managing partner and shareholder in the New York office of Anderson Kill. He is a trial lawyer who has obtained more than $5 billion in settlements and judgments for policyholders from insurance companies.*

Robert Y. Chung *is a shareholder in Anderson Kill's New York office with extensive experience in insurance coverage litigation, exclusively on behalf of policyholders.*

RISK MANAGEMENT