More Courts Discouraging Policyholder Settlements in Excess Claims Cases

by Robert M. Horkovich and Robert Y. Chung

As many policyholders have found, the insurance industry's promise of "seamless coverage" can be anything but. Policyholders often have to pursue insurance coverage for a single claim on an ad hoc basis against multiple insurance companies based upon a myriad of inconsistent denials. This is particularly troubling when a lower-level insurance company is willing to reach a reasonable settlement but the insurance company sitting above it digs in for slash and burn litigation.

Under those circumstance, long-standing case law sensibly has held that, where the policyholder's total loss exceeds the limits of the underlying insurance, the actual recovery against the underlying insurance company has no bearing on the excess insurance company's insuring obligations. Recently, however, some courts have turned this principle on its head, arguably requiring policyholders to obtain 100% payment of full limits from each underlying insurance company without any discount before becoming eligible to receive a dime from an excess insurance company.

Presently, a majority of jurisdictions follow what is sometimes called the "Zeig rule" and require an excess insurance company to pay its portion of a policyholder's covered loss up to the extent that excess coverage exceeds the limits of underlying insurance, regardless of the policyholder's ability to recover underlying insurance proceeds. In the seminal 1928 United States Court of Appeals case on the exhaustion of policy limits, Judge August Hand in Zeig v. Mass. Bonding & Ins. Co. held that an excess insurance company must provide insurance coverage if its layer of coverage has been pierced, even if the policyholder has settled with its underlying insurance company for less than the underlying policy's limits. Judge Hand observed that the excess insurance company "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." The Second Circuit reasoned that requiring "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 not convenient and commendable."

Numerous jurisdictions follow the well-settled Zeig rule. A few courts, however, recently have disregarded these principles and severely limited the ability of a policyholder to access paid-for excess insurance coverage. The effect of these decisions essentially is to discourage policyholders from entering into any reasonable settlements of underlying insurance for fear of negating excess insurance coverage.

Most recently, in 2011, the United States Court of Appeals for the Fifth Circuit's interpretation of Texas law in Citigroup, Inc. v. Federal Ins. Co. further has encouraged excess insurance companies to assert that they need not pay anything as losses that penetrate their excess layer until the underlying insurance companies pay 100% of their entire policy limits without any discount, regardless of whether, for example, the underlying insurance companies are unable to pay due to insolvency or enter into a settlement with the policyholder. These arguments, however, overstate the breadth of the Fifth Circuits' holding and, in any event, are contrary to long-standing insurance law.

Any anti-Zeig case flouts public policy by providing a disincentive for settlements between a policyholder and an underlying insurance company for anything less than the full limits of underlying insurance without discount, endorsing the forfeiture of a policyholder's excess insurance, and allowing an excess insurance company to collect substantial premiums without having to pay the benefits of excess insurance. These decisions ignore the practical realities of the world and chill settlements with lower-level insurance companies. An excess insurer should not be permitted to circumvent long-standing litigation and insurance coverage principles based upon circumstances which have no impact on its own obligations.

What can policyholders do to try to avoid forfeiting excess insurance coverage by entering into a reasonable settlement with a lower-level insurance company?

1. Look at your current excess insurance coverage closely. If it states that the underlying coverage has to be paid or be held liable to pay its limits before the excess insurance attaches, make sure that language is deleted on the very next renewal.

2. If you currently have such language in a policy year in which you have a claim and are in one of the few

jurisdictions that have case law not adopting the majority of cases following Judge Hand's decision in Zeig, consider a top down settlement strategy; that is, settling with the higher-level excess insurance companies first, before settling with underlying insurance companies.

3. If you cannot get that language out of your policy and excess insurance companies refuse to settle, you may consider legal proceedings against underlying insurance companies, holding them liable before settling with excess insurance companies. While this additional litigation is an unfortunate result of a few short-sighted anti-Zeig decisions and there may be costs associated with such an action, it may be less expensive than forfeiting excess insurance coverage or litigating against a finding of such forfeiture.

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