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

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October 3, 2013

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 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?"

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