New York Federal Bankruptcy Court Declines To Follow Zeig And Instead Holds That The Underlying Limits Must Be Actually Paid Before Third- Party Excess Policies Are Triggered
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On June 7, 2016, New York Federal Bankruptcy Judge Stuart M. Bernstein made a significant decision in an adversary proceeding, captioned Rapid-Am. Corp. v. Travelers Cas. & Sur. Co. (In re Rapid-Am. Corp.), 2016 Bankr. LEXIS 2224 (Bankr. S.D.N.Y. June 7, 2016), with respect to the excess insurers' obligations to provide coverage when the underlying limits have not been exhausted. The bankruptcy court ruled that because three of the four policies issued to Rapid American Corp. ("Rapid") contain language that requires exhaustion of the underlying limits through actual payment, the excess insurers had no duty to provide coverage under those policies.[1] In making this decision, the bankruptcy court rejected, among other things, the insured's argument that the rationale in Zeig v. Mass Bonding & Ins. Co., 23 F.2d 665 (2d Cir. 1928) is still applicable, and instead joined the other recent New York decisions nationwide that have explicitly departed from Zeig's rationale in the context of third-party liability policies and moved toward contract certainty in reviewing policy language.

In the adversary proceeding, Rapid, along with the Official Committee of Unsecured Creditors and the Future Claimants' Representative (the "Plaintiffs"), sought $64 million of remaining coverage under excess liability policies issued by Travelers Casualty and Surety Co., St. Paul Fire and Marine Insurance Co., and National Union Fire Insurance Company of Pittsburgh, Pa (the "Excess Insurers"). 2016 Bankr. LEXIS 2224 at 16. Plaintiffs alleged that Rapid has been involved in asbestos litigation since 1974, when they acquired The Philip Carey Manufacturing Co. Although Rapid settled many of the cases prior to filing the chapter 11 case, Plaintiffs alleged that Rapid still faces an estimated 275,000 in pending asbestos-related personal injury claims. Plaintiffs further alleged that Rapid has "spent, made, or committed to make at least $701,782,193.49 in indemnity payments and defense costs relating to asbestos claims." Id. The Excess Insurers denied liability, contending that coverage is barred because the Plaintiffs have not exhausted the underlying insurance policies. Id. Shortly after filing the adversary proceeding, the parties moved for summary judgment.

In ruling in favor of the Excess Insurers, the bankruptcy court rejected Plaintiffs' argument that Zeig mandates that the exhaustion language does not need to be read literally. Instead, the bankruptcy court found that "Zeig's continuing vitality is open to question" in light of the Second Circuit's decision in Ali v. Fed. Ins. Co., 719 F.3d 83 (2d. Cir. 2013), which distinguished Zeig on many grounds. More specifically, the Second Circuit in Ali noted that the policy at issue in Zeig involved first-party property insurance and as such, the insured had suffered out-of-pocket losses for settling with its primary insurer for less than the limits and in not recovering coverage from its excess insurer. Id. at 93. In contrast, the policies at issue in Ali provided coverage for third-party liabilities, which the Second Circuit noted was a critical difference because the relief requested focused on the insured's obligation to pay third-parties. Id. at 94. Moreover, the Second Circuit in Ali noted the excess insurers had bargained for language that required actual payment before coverage attached and further found that if insureds could attach liability based upon unpaid losses, they might be tempted to structure inflated settlements, which would have the effect

of an excess insurer having to "drop down" and assume coverage in place of insolvent insurers. Id. at 94. The bankruptcy court also noted the same issue was decided in Forest Labs., Inc., v. Arch Ins. Co., 984 N.Y.S.2d 361 (First Dept. 2014), where the plaintiff had settled with the underlying insurers for less than the policy limits and sought coverage from the final excess insurer. The Appellate Division in that case held that the trial court had properly determined the language of the excess policy was unambiguous in requiring that the prior layer of coverage had to be exhausted through actual payment.

Accordingly, as in Ali and Forest, the bankruptcy court held that "Rapid must exhaust the underlying primary and excess insurance through payment before coverage attaches." 2016 Bankr. LEXIS 2224 at 32-33. The bankruptcy court also distinguished Zeig for "the reasons explained by the Ali Court." Id.

The bankruptcy court also disagreed there was no danger of manipulating settlements because the court would review and supervise the settlements. As the bankruptcy court explained, its role in reviewing a settlement focuses on whether it benefits the estate and its creditors and as such, it does not focus its review on the impact upon non-debtor parties. Id. at 33-34. The bankruptcy court also set aside any attempt by Plaintiffs' to distinguish the Ali case because the policies there provided claims-made coverage, where, according to Plaintiffs, there was a high incentive not to preserve coverage. The bankruptcy explained there was no indication that such coverage played any factor into the Second Circuit's decision, and further concluded that even with an occurrence-based policy, there was still a risk of trying to manipulate a settlement where the underling policy was insolvent in order to reach the next level of coverage. Id. at 34.

Finally, the bankruptcy court rejected any notion that the Maintenance and Bankruptcy Clauses conflicted with each other. The Maintenance Clause is designed to protect the excess insurer from having to "drop down" in the event the insured fails to maintain a lower level policy or the lower level policy is invalidated. Accordingly, a settlement with an underlying insurer does not constitute a failure to maintain insurance, nor does it excuse the impairment requirement. Id. at 34. The bankruptcy court also found that the Bankruptcy Clause does not eliminate the exhaustion requirement either.[2] In examining the statutory requirement in N.Y. Ins. Law § 3420(a)(1) to include the Bankruptcy Clause, the bankruptcy court found that it is designed to protect a claimant or creditor injured by a bankrupt insured because it could not pay or did not have to pay the injured party, but in no manner did it excuse compliance with conditions precedent. Id. at 37-39. Moreover, it distinguished cases that relieved the insured from paying self-insured retentions ("SIRs") before the insurer's liability attaches because in those cases, the bankruptcy prevented the insured from satisfying the SIRs. In contrast, the policy language at issue in Rapid-American only requires that the amounts be paid by or on behalf of Rapid. Thus, the policies still permit some party other than Rapid to satisfy the exhaustion requirements and trigger coverage.[3]

In sum, the Rapid-American decision represents another favorable outcome for excess insurers under New York law, and further erodes any notion that the Zeig rationale applies in the context of third-party liability policies. The decision is particularly noteworthy given that the requirement to exhaust underlying limits by actual payment of claims must be satisfied even if the insured is bankrupt. The bankruptcy court's ruling is also the latest in a series of recent rulings from across the country, which have also rejected Zeig's rationale and instead have opted to enforce the policy terms as written in order to provide contract certainty and consistency. See, e.g., Intel Corp. v. American Guar. & Liab. Ins. Co., 2012 Del. LEXIS 480, Case No. 692, 2011 (Del. 2012); Comerica Inc. v. Zurich Amer. Ins. Co., 498 F. Supp. 2d 1019 (E.D. Mich. 2007); Qualcomm, Inc. v. Certain Underwriters at Lloyd's, London, 161 Cal. App. 4th 184 (Cal. Ct. App. 2008), review denied, 2008 Cal. LEXIS 6969 (Cal. Jun. 11, 2008). For more information on

these other decisions, please see our prior E-Alerts, dated 11/19/13, 10/4/12, 6/15/11 and 10/14/10.

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[1] In one of the excess policies, there was no requirement that the underlying limits must be exhausted.

[2] The Bankruptcy Clause provides that "[b]ankruptcy or insolvency of the Insured or of the Insured's estate shall not relieve the Company of any of its obligations hereunder."

[3] The bankruptcy court also rejected that the Plaintiffs' argument that Bankruptcy Code § 365 applies because insurance policies are not executory contracts.