Penny Wise and Pound Foolish?
Issues for Excess Insurers in the Wake of *Comerica* and *Qualcomm*

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I. Introduction

When a loss exceeds a primary insurer's limits, a question often arises: Must the policyholder exhaust the primary policy through actual payment of limits before recovering from its excess insurer? A substantial majority of courts has held that payment of primary limits is not a prerequisite for a policyholder to obtain coverage from its excess insurer. These courts often follow the Second Circuit's decision in *Zeig v. Massachusetts Bonding & Insurance Co.*, 23 F.2d 665 (2d Cir. 1928) ("*Zeig*"), which holds that a policyholder can settle with the primary, absorb the difference between the settlement and the primary limits, and seek coverage from the excess insurer for amounts in excess of the primary policy.

The recent decisions in *Comerica, Inc. v. Zurich American Insurance Co.*, 498 F. Supp. 2d 1019 (E.D. Mich. 2007), and *Qualcomm, Inc. v. Certain Underwriters at Lloyd's*, 161 Cal. App. 4th 184 (2008), depart from the *Zeig* rule. In both cases, the courts concluded that the exhaustion requirements of the excess policy precluded the policyholder from settling with its primary insurer for less than policy limits before seeking coverage from the excess.

While *Comerica* and *Qualcomm* appear significant victories for excess insurers, insurers should carefully consider whether to rely on these decisions. This article will begin by discussing *Zeig*, *Comerica*, and *Qualcomm* in detail, and then will look at the various considerations that may factor into an excess insurer's analysis on whether to depart from the *Zeig* rule. The issue is more complicated than simply interpreting policy language, particularly given that courts have reached differing results on similar language. Other aspects of the claim can be important, and *Zeig*'s policy of encouraging settlements should not be underestimated. Indeed, despite whatever immediate gains excess insurers may obtain from *Comerica* and *Qualcomm*, the insurance industry may be better off as a whole if courts follow the *Zeig* rule.

II. The *Zeig* Rule

To better appreciate the context in which *Comerica* and *Qualcomm* were decided, it is necessary to consider the analysis in *Zeig* which was – and remains – the dominant view on the issue of exhaustion.

In *Zeig*, a policyholder sought coverage under an excess burglary insurance policy for amounts exceeding the limits of three underlying policies. The excess policy stated that its insurance applied "only after all other insurance herein referred to shall have been exhausted in the payment of claims to the full amount of the expressed limits of such insurance." 23 F.2d at 665.

The three underlying policies had limits totaling $15,000, but the policyholder settled his claims against those policies for $6,000 and then turned to his excess insurer for coverage. *Id.* The excess insurer argued that its policy could incept only upon actual payment of the underlying limits. *Id.* The Second Circuit disagreed that policy compelled such a result. The court explained:

> The clause provides only that it be 'exhausted in the payment of claims to the full amount of the expressed limits.' 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 often is 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 amount of the primary policies. Only such portion of the loss as exceeded, not the cash settlement, but the limits of these policies, is covered by the excess policy.

Id. at 666.

While this analysis of the policy language would have sufficed to resolve the dispute, the *Zeig* court also offered a more pragmatic rationale for its decision – one that would be quoted repeatedly by subsequent courts:

> The defendant argues that it was necessary for the plaintiff actually to collect the full amount of the policies for $15,000, in order to 'exhaust' that insurance. Such a construction of the policy sued on seems unnecessarily stringent. It is doubtless true that the parties could impose such condition precedent to liability upon the policy, if they chose to do so. But the defendant 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. 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 an 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.

Courts around the country have followed *Zeig* in considering whether a policyholder can access excess coverage by settling with its primary insurer for less than the limits of liability and absorbing the difference between the primary insurer's payment and its coverage limits. *See* Barry R. Ostrager & Thomas R. Newman, Insurance Coverage Disputes, § 13.04 at 1059 (14th ed. 2008) (and cases cited therein). Many of these courts find compelling *Zeig*'s rationale on the importance of encouraging settlements. Indeed, some courts, such as the Minnesota Supreme Court in *Drake v. Ryan*, 514 N.W.2d 785, 789 (Minn. 1994), have suggested this consideration is so important (and the excess insurer's competing interest so negligible) that the *Zeig* analysis should apply regardless of the specific exhaustion language contained in the excess policy. *See*

also Rummel v. Lexington Ins. Co., 945 P.2d 970, 981 (N.M. 1997); *Elliott Co. v. Liberty Mut. Ins. Co.*, 434 F. Supp. 2d 483, 500 (N.D. Ohio 2006); *Reliance Ins. Co. v. Transamerica Ins. Co.*, 826 So. 2d 998, 999-1000 (Fla. Ct. App. 2001).

III. *Comerica* and *Qualcomm*

Two recent decisions, *Comerica* and *Qualcomm*, decline to follow *Zeig*. In both cases, the courts found that, according to their reading of the plain language of the excess policies, they were required to insist on actual payment of limits by the primary insurers before the excess insurers had any coverage obligation.

A. *Comerica*

The excess policy in *Comerica* contained a "Depletion of Underlying Limit(s)" provision, which stated in part:

> In the event of the depletion of the limit(s) of liability 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. . . . In the event of the exhaustion of the limit(s) of liability of such "Underlying Insurance" *solely as a result of payment of loss* thereunder, the remaining limits available under this Policy shall continue . . . for subsequent loss as primary insurance.

498 F. Supp. 2d at 1022 (emphasis added).

The excess policy also contained a "Maintenance of Underlying Insurance" provision, which stated in part:

> All of the "Underlying Insurance" scheduled in Item 3. of the Declarations shall be maintained during the "Policy Period" in full effect, except for any reduction of the aggregate limit(s) of liability available under the "Underlying Insurance" *solely by reason of payment of loss* thereunder.

Id. at 1023 (emphasis added).

The insured, Comerica, settled five securities fraud class action lawsuits against it for a total of $21 million. *Id.* at 1020. Its primary insurance policy carried a $20 million limit of liability. *Id.* The primary insurer raised a number of coverage concerns with Comerica's claims, but ultimately settled for $14 million – leaving a $6 million gap between the amount paid by the primary and the limits of its policy. *Id.*

Comerica elected to absorb the $6 million, and sought coverage from its excess insurer for the $1 million that exceeded the primary's limits. *Id.* The excess insurer denied the claim, arguing that the primary policy had not been properly exhausted by actual payment of loss. *Id.* at

1021. The United States District Court for the Eastern District of Michigan agreed with the excess insurer.

The *Comerica* court refused to apply *Zeig* because it believed the language of the excess policy unambiguously required that the primary insurance be exhausted or depleted by the actual payment of losses by the underlying insurer. *See id.* at 1030-32. According to the court, this never happened. *Id.* at 1032.

The court also expressed concern that Comerica's settlement with the primary insurer was somehow collusive, and thus suggested that the excess insurer had a reason for insisting on actual payment of the primary limits:

> Comerica had a fundamental disagreement with its primary insurer as to whether [it] was liable for any amount of the settlement. That dispute did not directly involve [the excess insurer], and Comerica did not have a right to tie [the excess] to any aspect of its settlement with [the primary] without [the excess insurer's] consent.

Id. at 1032.

The court reasoned that Comerica could have litigated its dispute with the primary, which would have involved the risk of losing all coverage, but which also could have resulted in a finding that the primary was liable for its policy limits – in which case the excess insurance would have been triggered. *Id.* That Comerica chose instead to settle was apparently cause for concern:

> Comerica seeks the certainty that its settlement brought and the benefit of coverage from its excess insurer as if it had won its dispute with the primary insurer, despite language in the excess policy to the contrary. No public policy argument says that Comerica can have its cake and eat it too.

Id.

B. *Qualcomm*

In *Qualcomm*, the California Court of Appeal applied a similar analysis to that of *Comerica*. Qualcomm had a primary policy with a $20 million limit of liability. *Id.* at 189. The excess policy contained the following language in its "Limit of Liability" section:

> 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.

161 Cal. App. 4th at 195.

Qualcomm was sued by its employees in a series of lawsuits asserting rights to unvested stock options. *Id.* at 188. After settling these lawsuits, Qualcomm negotiated with its director and officer liability insurers, including the primary and excess carriers. *Id.* at 189. Qualcomm ultimately entered into a settlement agreement with the primary insurer, whereby the primary agreed to pay a total $16 million for a release that included all future obligations under its policy. *Id.* Qualcomm then sued its excess insurer, seeking coverage for amounts in excess of the $20 million primary limits. *Id.*

The excess insurer demurred on the grounds that the excess policy required underlying exhaustion by payment of the primary's policy limits. *Id.* The trial court sustained the demurer and the California Court of Appeal agreed. *Id.*

The Court of Appeal concluded that the Limit of Liability section in the excess policy unambiguously required exhaustion of the entire amount of the underlying limits. *Id.* at 195. The court explained:

> In our view, the phrase "have paid … the full amount of ($20 million)," particularly when read in the context of the entire excess policy and its function as arising upon exhaustion of primary insurance, cannot have any other reasonable meaning that the actual payment of no less than the $20 million underlying limit.

Id.

Since Qualcomm could not show that its settlement with the primary insurer required the primary to accept responsibility (whether through immediate payment or an agreement to be liable) for the full amount of the $20 million limit, the court said the excess insurer was under no obligation to provide excess coverage. *Id.* at 196.

The *Qualcomm* court also reasoned that because it found the excess policy language to be unambiguous, it would not follow *Zeig*'s public policy rationale to reach a different result. *Id.* at 204.

IV. Considerations for Excess Insurers

While *Comerica* and *Qualcomm* represent a departure from the *Zeig* rule, an excess insurer should carefully consider its exhaustion argument before refusing to settle an excess claim based on these holdings. Among the many factors that may bear on this analysis are the following:

<u>The specific language of the excess policy</u>. The outcomes in *Comerica* and *Qualcomm* were based on specific policy language. As noted above, the critical factor in both cases is that courts found the excess policies to be specific and they were unwilling to allow public policy considerations to hold sway.

Qualcomm recognized, however, that exhaustion language of excess policies varies widely. 161 Cal. App. 4th at 200 (and cases cited therein). The insurer is well advised to consider how policy variations may affect the outcome.

The controlling law of the applicable jurisdiction. Though this factor need hardly be mentioned, it is worth considering for at least a couple of reasons. First, as demonstrated by the contrasting conclusions reached by *Zeig* and *Qualcomm*, courts have reached different conclusions about very similar language. In *Zeig*, the court considered a clause that required underlying coverage to be "exhausted in the payment of claims to the full amount of the expressed limits." 23 F.2d at 666. The *Zeig* court concluded that this provision did not preclude a below-limits settlement by the primary policies; it was only necessary that the loss exceeded the primary limits. *Id.* In *Qualcomm*, a "Limit of Liability" provision indicated the excess insurer would be liable after the underlying policies "have paid … the full amount of ($20 million)." 161 Cal. App. 4th at 195. The *Qualcomm* court said such a phrase "cannot have any other reasonable meaning that the actual payment of no less than the $20 million underlying limit." *Id.*

Second, as noted above, several courts have found the *Zeig* rationale in favor of settlements so persuasive that it may supersede other considerations.

Indeed, many jurisdictions will likely continue to apply the *Zeig* rule even in the face of language similar to that in *Comerica* and *Qualcomm* found compelling. Recently, in *HLTH Corp. v. Agricultural Excess & Surplus Insurance Co.*, 2008 WL 3413327, **14-15 (Del. Super. Ct. 2008), the Superior Court of Delaware held that a policyholder could accept settlements with underlying for less than limits and seek coverage from its excess insurers for amounts exceeding the underlying policies. The court reached this conclusion notwithstanding excess policy language that required the exhaustion by "paying . . . in legal currency" the underlying limit. *Id.* And the court expressly declined to accept the reasoning of *Qualcomm* and *Comerica*. *Id.* The Delaware court reasoned instead that the excess insurance company could not possibly claim to have a stake in whether the insured actually received all the underlying insurance limits. *Id.*

Have courts in the jurisdiction expressed a public policy in favor of settlement? A number of jurisdictions have yet to consider an excess insurer's obligations in the event of a settlement for less than the underlying limits. If courts in a given jurisdiction have previously expressed a strong policy preference in favor of settlements, they may be more inclined to apply a rationale similar to the *Zeig* rule. *See, e.g., Schmidt v. Clothier*, 338 N.W.2d 256, 260-261 (Minn. 1983) (purpose of no-fault act was to ease the burden of litigation and encourage prompt payment of claims; "[e]nforcement of policy exhaustion clauses would produce results contrary to those purposes"), *superseded by statute on other grounds recognized in Onasch v. Auto-Owners Ins. Co.*, 444 N.W.2d 587 (Minn. Ct. App. 1989).

Is the excess insurer able to express an interest in forcing the primary insurer to pay out every dollar of its limits? The *Zeig* court suggested that, so long as the excess is only called upon to pay a loss above the underlying limits, the excess has no rational interest in whether the insured collected the full amount of its underlying coverage. 23 F.2d at 666. If an excess insurer

can somehow demonstrate an interest in actual exhaustion of the underlying policies, it may improve its chances of avoiding the application of *Zeig*.

In *Qualcomm* and *Comerica*, the interest the courts recognized was the enforcement of policy language. The *Comerica* court also suggested it was worried about collusive settlements between the policyholder and its primary insurer. 498 F. Supp. 2d at 1032. On this point, however, the court was somewhat vague. The court implied that if Comerica litigated its coverage claim against the primary insurer, it might have recovered nothing. *Id.* Yet, said the court, "Comerica seeks the certainty that its settlement brought and the benefit of coverage as if it had won its dispute with the primary insurer, despite language in the excess policy to the contrary." *Id.*

Even if an excess insurer can demonstrate that the primary's settlement was for a highly speculative claim, it is unclear that a court will accept this as a basis for insisting on actual payment to exhaust the primary's limits. A court may conclude that such evidence simply goes to the excess insurer's other coverage defenses, not whether the policyholder must extract every dollar from the primary.

<u>Does the coverage dispute implicate multiple policy layers and periods?</u> In allocating claims over multiple policy periods, courts often expressly ignore "other insurance" clauses and other such provisions, reasoning that allocation is based on equitable principles. *See, e.g., Outboard Marine Ins. Corp. v. Liberty Mut. Ins. Co.*, 670 N.E.2d 740, 750 (Ill. Ct. App. 1996). In such a context, courts may be reticent to strictly apply exhaustion clauses – particularly if doing so would limit the possibility of settlements and force a trial on all coverage issues in a complex dispute.

<u>The excess insurer's potential liability for bad faith.</u> An excess insurer may face potential liability for bad faith if it does not coordinate with the policyholder and the primary insurer in attempting to resolve the claim. This is a particular risk in situations where the amount of the loss may exceed the limits of the excess policy. *See generally Majorowicz v. Allied Mut. Ins. Co.*, 569 N.W.2d 472 (Wis. Ct. App. 1997). In these situations, an excess insurer may be exposing itself to extra-contractual claims if it avoids opportunities to settle within limits by waiting until the underlying policy has been exhausted.

Another possible bad faith argument may come from the primary insurer. The primary could insist that by the excess's refusal to participate in settlement discussions prior to the primary's exhaustion scuttled a settlement and forced the primary to take on unnecessary defense costs. *See generally* COUCH ON INSURANCE 3D, § 198:20 at 198-39 (2005) (recognizing that a duty of good faith and fair dealing may run from an excess insurer to a primary insurer under certain circumstances).

<u>Does the exhaustion argument interfere with the primary insurance policy?</u> Some courts have indicated that excess insurers are strangers to the contract between the primary insurer and the policyholder. *See, e.g.*, *Loy v. Bunderson*, 320 N.W.2d 175, 189 (Wis. 1982). An excess insurer thus may face arguments that it is interfering in the contractual relationship of the primary policy. The primary insurer and/or the policyholder could argue that the excess insurer

is thwarting compromise and forcing the parties to incur unnecessary time and expense by requiring them to battle over full coverage for every claim that comes in the door.

<u>Are an excess insurer's interests served by insisting on exhaustion?</u> There may be an inherent tension between the immediate benefits to a particular excess insurer from insisting on full exhaustion of underlying limits in a given dispute, and the long-term harm done to insurers from a strict exhaustion requirement.

No doubt, the excess insurers in *Zeig*, *Qualcomm* and *Comerica* each saw an immediate and substantial benefit that would result if they could convince the court that they did not have to pay the claim.

In a larger context, however, the question arises as to whether it is in any party's interest – including the excess insurer – to foster more disputes between primary insurers and their policyholders. Coverage disputes become an all-or-nothing proposition. Either the policyholder agrees to walk away from coverage for a substantial claim, or it readies its case for trial. The advantages on both sides of settling – spending money to save transaction costs and avoid uncertainty – is gone. Primary insurers will insist on exacting proof before they agree to offer their limits.

The excess insurer may argue that this is exactly the result it wanted when it drafted the exhaustion clause in its policy. The result, however, comes with a big hook. More coverage disputes will go to litigation and excess insurers will be included. More disputes will be resolved later in litigation or through trial. And policyholders will be more fully invested in their claims by the time they can seek coverage from their excess insurers. In this context, excess insurers may well find themselves presented with settlement demands far higher than what they might have received in the absence of full-blown coverage litigation. The excess insurer will also face litigation costs it otherwise could have avoided. These problems multiply where the claim implicates multiple policy periods or multiple forms of coverage.

The benefits to insurers become even less certain in the long run. Many of the same insurers who write excess insurance also write primary coverage. Thus, any gains accruing to a company in its capacity as an excess insurer from insisting on a technical reading of an exhaustion provision may be more than offset when, in its capacity as a primary insurer in another case, it faces a similar argument. Obviously, this situation is impossible to quantify. But it may well present a tragedy of the commons for insurers: while excess insurers may continue to see it in their immediate interests to insist on full exhaustion by payment of the primary coverage, the overall impact to the industry of such an argument – in terms of increased transaction costs – could be detrimental.

V. Conclusion

Despite the apparent victories won by excess insurers in *Comerica* and *Qualcomm*, the pros and cons of exhaustion arguments are far more complicated than they may seem at first glance. Excess insurers would be wise to carefully weigh the range considerations implicated by

these decisions – including both short- and long-term consequences – before deciding whether to insist that settlements of underlying policies preclude excess coverage.