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**EXHAUSTION AND UNDERLYING POLICIES**

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## **EXHAUSTION AND UNDERLYING POLICIES**

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### **I. INTRODUCTION**

Excess policies provide additional layers of coverage for losses that exceed the limits of an underlying or primary insurance policy.<sup>1</sup> Coverage under an excess policy generally attaches when the limits of the primary policy (or lower-level underlying excess policies) have been “exhausted.” This paper addresses how courts determine whether exhaustion has occurred so as to trigger an excess insurer’s coverage.

What constitutes “exhaustion” depends on both the policy language and applicable law.<sup>2</sup> Unfortunately, there is little caselaw specifically addressing exhaustion in the context of fidelity coverage, but cases dealing with other types of insurance provide guidance, and indeed the applicable provisions of both excess fidelity and excess liability policies may be similar or even identical. For example, most excess policies contain specific exhaustion language, in an exhaustion clause, a “drop down” clause, or in the insuring agreement itself. In *Times-Picayune Publishing Corp. v. Zurich American Insurance Co.*, the Fifth Circuit considered an excess employee dishonesty policy containing an “Insuring Clause” that provided:

The Underwriter shall provide the Insureds with insurance coverage during the Policy Period excess of the Underlying Insurance. Coverage under this policy *shall attach only after all of the Limit(s) of Liability of the Underlying Insurance has been exhausted by the actual payment of loss(es)*. Except as otherwise provided herein, coverage under this policy shall then apply in conformance with and subject to the warranties, limitations, conditions, provisions, and other terms of the Primary Policy as in effect the first day of the Policy Period, together with the warranties and limitations of any other Underlying Insurance. In no event shall coverage under this policy be broader than coverage under any Underlying Insurance.<sup>3</sup>

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<sup>1</sup> *Gerling Global Reinsurance*, 419 F.3d at 183 n. 2 (citing *North River Ins. Co. v. ACE Am. Reinsurance Co.*, 00-7993, 2002 WL 506682, at \*1 (S.D.N.Y. Mar. 29, 2002)). An excess policy often provides coverage under the same terms as the underlying primary policy, essentially “following the form” of the primary policy. *Scottsdale Ins. Co. v. Safeco Ins. Co. of Am.*, 111 F. Supp. 2d 1273, 1278 (M.D. Ala. 2000).

<sup>2</sup> *Horace Mann Ins. Co. v. Gen. Star Nat’l Ins. Co.*, 514 F.3d 327, 329 (4th Cir. 2008); (quoting *Gauze*, 633 S.E.2d at 332); 15 Lee R. Russ & Thomas F. Segalla, *COUCH ON INSURANCE* § 220:32 (3d ed. 2005)).

<sup>3</sup> 421 F.3d 328, 332 (5th Cir. 2005) (emphasis added). Although exhaustion was an issue, the *Times-Picayune* case presents an unusual fact pattern. An employee of the Times-Picayune embezzled \$2,205,879 over the course of six years, during each of which the insured had in place consecutive \$1,000,000 one-year policies covering employee dishonesty issued by Federal Insurance Company (“Federal”). *Id.* at 329-30. The Federal policies covered losses that occurred during the effective period of the policy and were discovered within one year of the expiration date. *Id.* at 329. Each policy also contained a prior loss provision, extending coverage up to the limits of one policy for losses that occurred prior to the effective period of the policy but during a preceding consecutive period of identical coverage. *Id.* The Times-Picayune also obtained a three-year \$1.5

Exhaustion language varies considerably from policy to policy. For example, some policies provide that liability will not attach until the primary insurer “has paid” the amount of the underlying limits; or that liability “shall not attach unless and until the insured, or the insured’s underlying insurer, shall have paid the amount of the underlying limits;” or that the excess insurer “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.”<sup>4</sup>

The Zurich American policy in the *Times-Picayune* case also contained a “drop down” clause entitled “Reduction/ Exhaustion of Underlying Limits,” explaining the coverage provided in the event of exhaustion of the primary policy limits:

In the event and only in the event of the reduction or exhaustion of the Limit(s) of Liability of the Underlying Insurance solely as the result of actual payment of loss covered thereunder, this policy shall: (i) in the event of reduction, pay excess of the reduced Limit(s) of Liability of the Underlying Insurance, and (ii) in the event of exhaustion, continue in force as primary insurance excess of the retention applicable in the Primary Policy, which retention shall be applied to any subsequent loss as specified in the Primary Policy.

Notwithstanding any of the terms of this policy which might be construed otherwise, this policy shall drop down only in the event of reduction or exhaustion of the Underlying Insurance by the actual payment of loss and shall not drop down for any other reason including, but not limited to, uncollectibility (in whole or in part) of any Underlying Insurance. The risk of uncollectibility of such underlying Insurance (in whole or in part) whether because of financial impairment or insolvency of the underlying insurer or for any other reason, is expressly retained by the Insureds and is not in any way or under any circumstances insured or assumed by the Underwriter.<sup>5</sup>

This detailed language was presumably included in an attempt to limit the excess insurer’s liability if the event of the primary insurer’s insolvency. “As insurer insolvencies have become more

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million excess policy from Zurich American Insurance Company (“Zurich”) that was effective during the periods of the fourth, fifth and sixth Federal primary policies. *Id.* at 330. The *Times-Picayune*’s loss occurred as follows: \$536,428 during the first policy period; \$268,871 during the second policy period; \$234,707 during the third policy period; \$330,647 during the fourth policy period; \$562,859 during the fifth policy period; and \$272,367 during the sixth policy period. *Id.* The *Times-Picayune* discovered the loss during the sixth policy period and timely notified Federal, which paid the \$1,000,000 policy limits. *Id.* The *Times-Picayune* then sought from Zurich coverage for its remaining loss of \$1,205,879. *Id.* Zurich, however, argued that because only \$1,165,873 was stolen during its three-year policy period, it was liable for only \$165,873, the amount of such loss that exceeded the underlying policy limit. *Id.* The Fifth Circuit concluded that Zurich was liable for the full amount of the *Times-Picayune*’s unpaid loss because “there is nothing in the plain language of the excess policy clearly stating that Zurich is *only* bound to pay for losses (exceeding \$1,000,000) which were incurred during the period of its policy.” *Id.* at 336.

<sup>4</sup> As noted by the court in *Qualcomm, Inc. v. Certain Underwriters at Lloyd’s*, 161 Cal. App. 4th 184, 73 Cal. Rptr. 3d 770, 782 (Cal. App. 2008), exhaustion clauses may be “phrased in a multiplicity of ways.”

<sup>5</sup> *Times-Picayune*, 421 F.3d at 332.

common, the issue of whether an excess insurer is obligated to ‘drop down’ and assume the responsibilities of an insolvent primary insurer has been frequently litigated. Employing various theories, some jurisdictions have required excess insurers to insure the full loss when the primary insurer is insolvent.”<sup>6</sup>

Other policy language may also play a role in an exhaustion analysis. For example, most excess policies contain a “maintenance of underlying insurance” clause requiring the insured to maintain its primary insurance. Endorsement language should also be considered. Finally, the policy’s “other insurance” clause may also be pertinent, particularly if there are multiple insurers at the same level.<sup>7</sup>

Although there is no question that a true excess insurer’s coverage is triggered only when the limits of the underlying insurance have been exhausted, there is considerable disagreement over what constitutes “exhaustion.”<sup>8</sup> While exhaustion should be deemed to have occurred if the underlying insurer has actually paid the full amount of the underlying limits, the outcome is less clear when the insured has, for example, settled a claim with the underlying insurer for less than the policy limits and stipulated to exhaustion in the settlement agreement. Determining when exhaustion occurs is further complicated by the fact that policy language can vary widely. While analysis may be difficult, determining whether (and when) exhaustion occurs is crucial to

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<sup>6</sup> *Waste Mgmt. of Minnesota, Inc. v. Transcontinental Ins. Co.*, 502 F.3d 769, 772 (8th Cir. 2007).

<sup>7</sup> The “other insurance” clause is generally not at play in a coverage dispute between a primary policy and an excess policy, because the primary policy is first in line, even if it contains an “excess” other insurance clause. 15 Russ & Segalla, COUCH ON INSURANCE § 218:5 (“An ‘other insurance’ dispute cannot arise between primary insurers and true excess insurers.”); *Horace Mann Ins. Co. v. Gen. Star Nat’l Ins. Co.*, 514 F.3d 327, 334-35 (4th Cir. 2008) (“[T]he general rule is that as between a true excess policy and a primary liability policy with an other-insurance clause, the limits of the policy that provides primary insurance must *always* be exhausted before coverage under the excess policy is triggered.”) (citing *Monroe Guar. Ins. Co. v. Langreck*, 816 N.E.2d 485, 492-93 (Ind. App. 2004); *Gen. Star Nat’l Ins. Co. v. World Oil Co.*, 973 F. Supp. 943, 949 (C.D. Cal. 1997); *Nat’l Farmers Union Prop. & Cas. Co. v. Farm & City Ins. Co.*, 689 N.W.2d 619, 624 (S.D. 2004); *Nat’l Surety Corp. v. Ranger Ins. Co.*, 260 F.3d 881, 884 (8th Cir. 2001); *Am. Cas. Co. of Reading v. MAG Mut. Ins. Co.*, 06-11110, 2006 WL 1933806 (11th Cir. July 13, 2006), 185 Fed. Appx. 921; *Institute for Shipboard Educ. v. Cigna Worldwide Ins. Co.*, 22 F.3d 414, 425-26 (2d Cir. 1994); *LeMars Mut. Ins. Co. v. Farm & City Ins. Co.*, 494 N.W.2d 216, 218-19 (Iowa 1992); *Atkinson v. Atkinson*, 254 Ga. 70, 326 S.E.2d 206, 214 (1985); *North River Ins. Co. v. Am. Home Assur. Co.*, 210 Cal. App. 3d 108, 257 Cal. Rptr. 129, 132 (1989); *Allstate Ins. Co. v. Frank B. Hall & Co. of Ca.*, 770 P.2d 1342, 1347 (Co. Ct. App. 1989)). *But see Scottsdale Ins. Co. v. Safeco Ins. Co. of Am.*, 111 F. Supp. 2d 1273, 1277-81 (M.D. Ala. 2000) (after analyzing language of pertinent policies and under facts presented, concluding that excess policy was liable for payment of settlement over limits of primary policy rather than separate primary policy with an excess clause).

<sup>8</sup> See, e.g., *Steve D. Thompson Trucking, Inc. v. Twin City Fire Ins. Co.*, 832 F.2d 309, 310 (5th Cir. 1987) (“In general, an excess insurance policy provides coverage that begins only after a predetermined amount of primary coverage is exhausted.”); *St. Paul Mercury Ins. Co. v. Lexington Ins. Co.*, 78 F.3d 202 (Tex. 1996) (“primary policies’ limits must be exhausted before excess insurers become liable”); *Motorists Mut. Ins. Co. v. Glass*, 996 S.W.2d 437, 453 (Ky. 1997) (“As the ‘excess’ insurer, it did not owe any coverage until [the] primary coverage was exhausted.”); *Hammersmith v. TIG Ins. Co.*, 480 F.3d 220, 236-37 (3d Cir. 2007) (“Unlike primary insurers, excess insurers’ ‘coverage does not immediately attach after an occurrence, but rather attaches only after the primary coverage for the occurrence is exhausted.’”) (citing *Am. Home Assur. Co. v. Int’l Ins. Co.*, 90 N.Y.2d 433, 661 N.Y.S.2d 584, 684 N.E.2d 14, 17 (1997)).

determining the obligations of primary and excess insurers – both to indemnify and to defend their insured.<sup>9</sup>

## II. COURT APPROACHES TO EXHAUSTION

Determining whether exhaustion has occurred depends on the language of the excess policy and the controlling law. For example, policies that require payment as a prerequisite for exhaustion are more likely to be enforced to the letter, with substitute payment of primary limits by the insured or another party being irrelevant to fulfillment of the primary insurer's obligations. Likewise, policies that lack "payment" language are more prone to a finding of exhaustion through substitute actions.

Courts generally follow one of two approaches in determining whether exhaustion has occurred. First, many courts follow the analysis applied by the Second Circuit in *Zeig v. Massachusetts Bonding & Insurance Co.*, in which the court concluded that the excess insurer was liable for the portion of the insured's loss in excess of the primary policy limits, regardless of whether the insured actually collected those limits from the primary insurer.<sup>10</sup> Generally, courts apply this analysis when the policy language does not explicitly require payment by the primary insurer, or where they deem the policy language to be ambiguous. In a second line of cases, courts have strictly interpreted policy language as written, rejecting *Zeig* and requiring actual payment of the underlying limits as a condition precedent to coverage.

### A. Exhaustion Occurs Where the Loss Exceeds the Underlying Limits.

*Zeig* is without doubt the most frequently cited decision in any exhaustion dispute. In *Zeig*, the Second Circuit considered whether the insured was entitled to coverage under its excess policy when it settled claims under its primary burglary insurance policies for \$6,000 rather than

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<sup>9</sup> Consider a scenario where an insured financial institution is engaged in ongoing litigation with hundreds of claimants following loss of its clients' funds resulting from wrongful conduct by its employees. At this point, the primary insurer owes a duty to defend the insured and reimburse the insured's ongoing defense costs. However, if a court renders judgment against the insured and the primary insurer for the full amount of the underlying policy limits in connection with *the first* claim, and the policy states that exhaustion occurs when the underlying insurer has paid *or been held liable in judgment for* the full amount of the policy limits, exhaustion should be deemed to have occurred at the time of judgment, and the duty to defend will shift from the primary insurer to the excess insurer. However, if the policy states that exhaustion occurs only when the primary insurer has actually paid the underlying limits, the excess insurer's obligations may not arise until the primary insurer actually satisfies the judgment. If the primary takes a few months to do so, it would be on the hook for all defense costs incurred by its insured during this period. Obviously, this scenario assumes that the excess insurer owes a duty to defend and that the duty arises at the time the primary policy limits are exhausted. "The majority rule is that where an insured maintains both primary and excess policies ... the excess insurer is not obligated to participate in the defense until the primary policy limits are exhausted.... The premiums charged are ... a reflection of the risks undertaken. Because the primary insurer's duty to defend extends to covered claims without regard to their amount, an excess insurer's duty to defend is not typically invoked merely because a claim has been asserted against the insured in excess of primary limits." *State Industries, Inc. v. Twin City Fire Ins. Co.*, 158 Fed. Appx. 694, 697 (6th Cir. 2005).

<sup>10</sup> 23 F.2d 665, 666 (2d Cir. 1928).

for the underlying liability limit of \$15,000.<sup>11</sup> The excess policy provided that it “shall apply and cover 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 other insurance.”<sup>12</sup> The excess insurer argued that the insured was required to collect the full amount of underlying insurance before it could claim coverage under the excess policy, but the *Zeig* court rejected the insurer’s argument as “unnecessarily stringent,” stating that:

It is doubtless true that the parties could impose such a condition precedent to liability upon the policy, if they chose to do so. But the [excess insurer] 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 interest to the insurer, ought only to be reached when the terms of the contract demand it.<sup>13</sup>

The court reasoned that because the excess policy language did not specifically require “collection” of the underlying policy limits, it would not construe the policy in a “burdensome” way to the insured. Accordingly, the court determined that “claims are paid to the full amount of the policies, if they are settled and discharged, and the primary insurance is thereby exhausted.”<sup>14</sup>

Courts following *Zeig* generally reason that a broad interpretation of the policy favors the efficient settlement of disputes between insurers and insureds. Further, in many cases, courts find the policy language to be ambiguous or to lack specificity regarding how the primary insurance must be discharged.<sup>15</sup> For example, in *Pereira v. National Union Fire Insurance Co. of Pittsburgh, P.A.*, the court considered whether excess coverage could be triggered where one of the underlying insurers had become insolvent.<sup>16</sup> The court found coverage based not on an ambiguity

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<sup>11</sup> 23 F.2d at 665.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.* at 666.

<sup>14</sup> *Id.*

<sup>15</sup> See, e.g., *Qualcomm, Inc. v. Certain Underwriters at Lloyd’s*, 161 Cal. App. 4th 184, 73 Cal. Rptr. 3d 770, 782 (Cal. App. 2008) (citing *Drake v. Ryan*, 514 N.W.2d 785, 789 (Minn. 1994); *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. App. 2001)); *Comerica Inc. v. Zurich Am. Ins. Co.*, 498 F. Supp. 2d 1019, 1030 (E.D. Mich. 2007) (citing *Stargatt v. Fidelity & Cas. Co. of N.Y.*, 67 F.R.D. 689 (D. Del. 1975); *Gasquet v. Commercial Union Ins. Co.*, 391 So. 2d 466 (La. Ct. App. 1980)); accord *Archer Daniels Midland Co. v. Aon Risk Servs. Inc. of Minn.*, 356 F.3d 850, 859 (8th Cir. 2004) (holding that insured’s settlement with underlying insurers for less than \$50 million underlying limit and absorption of balance was sufficient to trigger coverage under excess policy).

<sup>16</sup> 04-1134, 2006 WL 1982789, \*7 (S.D.N.Y. July 12, 2006).

in the policy language, but on a policy basis, citing the reasoning of the *Zeig* court.<sup>17</sup> The *Pereira* court concluded that:

Interpreting the policy to excuse the excess insurers from providing coverage within their respective layers on account of the unrelated insolvency of an intermediary insurer would work a similar hardship on the insureds, who have already been deprived of a layer of coverage by the insolvency, and provide a windfall to the excess insurers.<sup>18</sup>

Similarly, in *Rummel v. Lexington Insurance Co.*, the court considered whether coverage under an excess policy had been triggered where none of the underlying insurers had paid the full amounts of the underlying limits: one refused to pay, one negotiated a settlement for less than the policy limits, and the insured itself was insolvent and could not pay its self-insured retention because of bankruptcy.<sup>19</sup> The excess insurer argued that the full payment of the underlying limits in cash was a condition precedent that none of the three underlying insurers had fulfilled.<sup>20</sup>

The *Rummel* court emphasized that resolution of the exhaustion issue had to be based “on the facts of this particular case and on the language of the individual insurance contract.”<sup>21</sup> The excess policy provided that “[l]iability of the Company under this policy shall not attach unless and until the Insured’s Underlying Insurance *has paid or has been held liable to pay* the total applicable underlying limits.”<sup>22</sup> The insuring agreement further provided that “Lexington Insurance Company ... in consideration of the payment of premium and in reliance upon the statements in the Declarations made a part thereof, hereby agrees to indemnify [Circle K Corporation] *against “loss”* which is [in] excess of the total limit(s) of all Underlying Insurance ... subject to the limit of liability [of \$10,000,000].”<sup>23</sup> “Loss” was defined as “*sums paid or payable* in settlement of claims for which the Insured is liable after making deductions for all other recoveries, salvages or other insurance (other than recoveries under underlying insurance, *whether recoverable or not*) and shall exclude all expenses and costs.”<sup>24</sup> The court found that this language specifically allowed for situations

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<sup>17</sup> *Id.* The *Pereira* court quoted with approval the *Zeig* court’s conclusion that interpreting the policy “language to require that the underlying insurance had to be exhausted by actual collection was ‘harmful to the insured and of no rational advantage to the insurer [and] ought only to be reached when the terms of the contract demand it’” and that there was “nothing in the clause before [it] to require a construction so burdensome to the insured.” *Id.* (quoting *Zeig*, 23 F.2d at 666).

<sup>18</sup> *Id.*

<sup>19</sup> 945 P.2d 970, 977 (N.M. 1997).

<sup>20</sup> *Id.*

<sup>21</sup> *Id.* The *Rummel* court did concede that the parties could agree that an excess insurer’s liability would not arise absent full payment by the primary insurer if the policy terms are clear and explicit. *Id.* at 979.

<sup>22</sup> *Id.* at 977 (emphasis in original).

<sup>23</sup> *Id.* at 978 (emphasis in original).

<sup>24</sup> *Id.* (emphasis in original).

in which an insurer was obligated to pay, but had not and may never make payment.<sup>25</sup> Accordingly, the court concluded that the actual cash payment of the policy limits by the underlying insurer was not required.<sup>26</sup>

Likewise, in *Reliance Insurance Co. v. Transamerica Insurance Co.*,<sup>27</sup> and *Archer Daniels Midland v. Aon Risk Services, Inc. of Minnesota*,<sup>28</sup> the courts relied on *Zeig* in rejecting the excess insurers' arguments that their policies could not be triggered where the primary insurers settled with their insureds for less than the policy limits. A similar result was reached in *Gasquet v. Commercial Union Insurance Co.*, in which the court held that an excess policy was triggered by a settlement that gave the excess carrier a credit for the policy limits of the primary insurer.<sup>29</sup>

Although courts following *Zeig* generally find an ambiguity in the policy language, or determine that the policy does not actually require payment to establish exhaustion, at least one case has found, purportedly in reliance on *Zeig*, that exhaustion occurs where the insured has sustained a loss in excess of the policy limits but has settled claims with its primary insurer for an amount less than the policy limits, *even if the policy language expressly requires payment*. In *HLTH Corp. v. Agricultural Excess & Surplus Ins. Co.*, the excess policy provided that:

Only in the event of exhaustion of the Underlying Limit by reason of the insurers of the Underlying Insurance, or the insureds in the event of financial impairment or insolvency of an insurer of the Underlying Insurance, *paying in legal currency* loss which, except for the amount thereof, would have been covered hereunder, this policy shall continue in force as primary insurance, subject to its terms and conditions and any retention applicable to the Primary Policy....<sup>30</sup>

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<sup>25</sup> *Id.* at 978.

<sup>26</sup> *Id.*

<sup>27</sup> 826 So. 2d 998, 999-1000 (Fla. App. 2001). The court ultimately found in favor of the excess insurer, however, because pursuant to the settlement, the insured had improperly assigned to the primary insurer its rights against the excess insurer. *Reliance*, 826 So. 2d at 1000-01. The court found that such an agreement, effectively permitting the primary insurer to shift its risk of loss to the excess insurer, was against public policy. *Id.* at 1000. The court held that:

When a primary carrier determines that the insured's loss is in excess of the primary limit, the duty of the primary carrier is to pay its insured and allow the insured to go forward with its claims against the excess carrier. Here, there is no question that at the time it was negotiating a settlement with its insured, the primary carrier had reached the conclusion that the insured had a viable claim against the excess carrier because it specifically negotiated for an assignment of that claim at the time of the settlement. This was a breach of duty to the insured and apparently an attempt to shift the loss from the primary carrier to the excess.

*Id.* at 1000-01.

<sup>28</sup> CIV. 97-2185JRTRLE, 1999 WL 34818933 (D. Minn. February 25, 1999) (not published in F. Supp.).

<sup>29</sup> 391 So. 2d 466, 471-72 (La. Ct. App. 1980)

<sup>30</sup> C.A. No. 07C-09-102 RRC, 2008 WL 3413327, \*4, \*14-\*15 (Del. Super. July 31, 2008) (Not Reported in A.2d) (emphasis added).

The plaintiffs argued that this provision should not be strictly interpreted to require full payment of the underlying policy limits before excess coverage is triggered because such an interpretation would be “against public policy as ‘the law favors settlement’ and irrelevant because ‘Federal would not be required to pay one penny more in insurance than it would have if the underlying insurance company paid its limits in full.’”<sup>31</sup> The court agreed, finding that exhaustion had occurred “as a matter of law” where the insured had reached settlements with two of its primary insurers for amounts less than the policy limits.<sup>32</sup>

## **B. The Policy Is Enforced As Written.**

A second line of cases departs from *Zeig*, strictly interpreting policy language requiring payment of the underlying policy limits as a condition precedent to coverage under the excess policy. Accordingly, these cases hold that settlement for less than the primary policy limits does not constitute exhaustion.

In *Comerica, Inc. v. Zurich American Insurance Co.*, the court considered whether an excess policy provided coverage and defense obligations where the insured and its primary insurer settled an underlying suit for \$21 million, with the primary insurer paying \$14 million of the settlement, some \$6 million less than its policy limits.<sup>33</sup> The insured argued that it could bridge the gap, rendering the excess insurer liable for \$1 million in connection with the settlement, as well as approximately \$2.6 million in defense costs.<sup>34</sup> However, the court rejected this argument, concluding that such an interpretation of the policy was not consistent with its plain language requiring exhaustion “by payment of judgments or settlements.”<sup>35</sup> According to the court:

[T]he excess policy in this case likewise requires that the primary insurance be exhausted or depleted by the actual payment of losses by the underlying insurer. Payments by the insured to fill the gap, settlements that extinguish liability up to the primary insurer’s limits, and agreements to give the excess insurer “credit” against a judgment or settlement up to the primary insurer’s liability limit are not the same as actual payment. Zurich’s policy requires “actual payment of losses” by the underlying insurer and states that its “policy does not provide coverage for any loss not covered by the ‘Underlying Insurance’ except and to the extent that such loss is not paid under the ‘Underlying Insurance’ solely by reason of the reduction or exhaustion of the available ‘Underlying Insurance’ through payments of loss thereunder.” That never happened in this case.<sup>36</sup>

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<sup>31</sup> *Id.* at \*8.

<sup>32</sup> *Id.* at \*14-\*15.

<sup>33</sup> 498 F. Supp. 2d 1019, 1020-21, 1032 (E.D. Mich. 2007).

<sup>34</sup> *Id.*

<sup>35</sup> *Id.* at 1031.

<sup>36</sup> *Id.* at 1032.

The *Comerica* court emphasized that, where policy language is specific, the exhaustion issue is more easily resolved.<sup>37</sup> For example, in *Danbeck v. American Family Mutual Insurance Co.*, the court held that, “while the ‘settlement plus credit’ approach to exhaustion has the same practical effect as payment of full policy limits, it is not consistent with the plain language of the policy, which unambiguously requires exhaustion ‘by payment of judgements or settlements,’ not ‘settlement plus credit.’”<sup>38</sup> Further, while recognizing the public policy favoring settlement, the court stated that this policy, “as important as it is, cannot supersede unambiguous policy language or impose obligations under the contract which otherwise do not exist. The generalized public policy favoring settlements is insufficient to justify voiding or refusing to enforce the clear language of the policy in this case.”<sup>39</sup>

Similarly, in *Wright v. Newman*, plaintiffs injured in an auto accident entered into a partial settlement with the defendant driver and his employer, which had a primary insurance policy from Guaranty National Insurance (“Guaranty”) with a limit of \$300,000, an excess policy from Bellefonte Insurance Company (“Bellefonte”) for \$200,000, and an excess policy with a limit of \$3,000,000 from Mission Insurance Company (“Mission”).<sup>40</sup> After a bench trial, the plaintiffs were awarded nearly \$6 million, which they sought to enforce against Mission, whose policy provided that “[l]iability ... shall not attach unless and until the Primary and Underlying Excess Insurers shall have admitted liability for ... [their] Limit(s) or unless and until ... and only after the Primary and Underlying Excess Insurers have paid or been held liable to pay the full amount of ... [their] Limits.”<sup>41</sup> However, because neither Guaranty nor Bellefonte had admitted liability or been found liable, the court found that the Mission policy had not been triggered.<sup>42</sup> The court concluded that it “could not very well apply *Zeig*’s reasoning here, even if [it] personally accepted that reasoning, since to do so would appear to run headlong into the clear Colorado rule that an insurance policy must generally be enforced as written.”<sup>43</sup>

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<sup>37</sup> *Id.* at 1030.

<sup>38</sup> *Comerica*, 498 F. Supp. 2d at 1031 (quoting 245 Wis. 2d 186, 190, 194, 629 N.W.2d 150 (2001)). See also *Aerojet-General Corp. v. Transcontinental Ins. Co.*, 036514, 2002 WL 1265692, \*13 (Cal. App. June 7, 2002) (insured’s buy-back of certain primary policies, for an amount less than the policy limits, could not be used to establish that the primary policies had been exhausted); *Consolidated Edison Co. of N.Y. v. Fyn Paint & Lacquer Co.*, 00-3764, 2005 WL 139170 (E.D.N.Y. Jan. 24, 2005) (excess insurer had no duty to defend an underlying action arising from alleged environmental contamination of property where insureds entered into buy-back arrangement with one of their primary insurers, because any potential judgment would have to be allocated over the forty years contamination occurred, and insureds did not establish that their actual liability incurred during each of the years the excess policies were in effect would exceed the \$100,000 primary policy limit, or that their total liability would exceed \$4 million (\$100,000 multiplied by forty years)).

<sup>39</sup> *Id.* (quoting *Danbeck*, 245 Wis. 2d at 197-98).

<sup>40</sup> *Comerica*, 498 F. Supp. 2d at 1031 (citing *Wright*, 598 F. Supp. 1178, 1196 (D.C. Mo. 1984)).

<sup>41</sup> *Id.* (quoting *Wright*, 598 F. Supp. at 1196).

<sup>42</sup> *Id.* at 1031-32 (quoting *Wright*, 598 F. Supp. at 1196-97).

<sup>43</sup> *Id.* (quoting *Wright*, 598 F. Supp. at 1197).

In *Federal Insurance Co. v. Srivastava*, the court considered whether the primary policy limits had been exhausted within the meaning of the insuring agreement of the excess policy, which provided that “[Federal] agrees to pay on behalf of the insured LOSS resulting from any occurrence insured by the terms and provisions of the First UNDERLYING INSURANCE policy..... The insurance afforded by this policy shall apply only in excess of and after all UNDERLYING INSURANCE ... has been exhausted.” The policy defined a “LOSS” as “the amount of the principal sum, award or verdict, actually paid or payable in cash in the settlement or satisfaction of claim for which the Insured is liable, either by adjudication or compromise with the written consent of [Federal]....”<sup>44</sup>

The insured argued that the amount of the loss became fixed when the district court entered judgment for an amount in excess of the underlying policy limits. However, that judgment was suspended on appeal, during which time a settlement partially extinguishing the judgment was reached. The court determined that the amount of the loss should be determined by the actual value of the settlement, including both the amounts payable by the settling parties and the unextinguished portion of the judgment. Because that loss did not reach the threshold of the excess policy, the *Srivastava* court found that the excess insurer had no liability.

And in *Qualcomm, Inc. v. Certain Underwriters at Lloyd’s*, the court considered whether the \$20 million limit of a primary policy issued to Qualcomm, Incorporated (“Qualcomm”) by National Union Fire Insurance Company of Pittsburgh, PA (“National”) could be deemed to have been exhausted so as to trigger coverage under an excess insurance policy issued by Certain Underwriters at Lloyd’s, London (“Underwriters”), where Qualcomm settled with National for an amount below the primary policy limit.<sup>45</sup> Qualcomm argued that even though the primary insurer never paid the full amount of its policy limit, the excess insurer was obligated to indemnify it for its unreimbursed litigation expenses and settlement costs in excess of the primary limit.<sup>46</sup>

The exhaustion clause in the Underwriters policy provided: “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.”<sup>47</sup> The *Qualcomm* court determined that this clause was clear, explicit and unambiguous, and held that:

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 than actual payment of no less than the \$20 million underlying limit.... We conclude that under the referenced portion of the exhaustion clause, Underwriters’ liability—its

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<sup>44</sup> 2 F.3d 98, 100, 102-03 (5th Cir. 1993).

<sup>45</sup> 161 Cal. App. 4th 184, 73 Cal. Rptr. 3d 770, 772 (Cal. App. 2008).

<sup>46</sup> *Id.* at 774.

<sup>47</sup> *Id.* at 778.

reimbursement obligation—did not arise until National actually paid the *full \$20 million amount* of its underlying limit.<sup>48</sup>

Similarly, in *BBL-McCarthy, LLC v. Baldwin Paving Co.*, the court strictly construed the exhaustion provisions of an excess policy issued by National Union Fire Insurance Company.<sup>49</sup> The primary insurer sought to shift the obligation to defend the insured to the excess insurer by tendering the remaining policy limits to the excess insurer and claiming exhaustion.<sup>50</sup> The court held that:

The term “exhaust” as it applies to policy limits means the payment either of a settlement or of a judgment, which wholly depletes the policy amount. Here, [the primary insurer] concedes that it did not “exhaust” its policy limits by paying the entirety toward either a judgment or settlement. Thus, [the primary insurer’s] tender of the remaining liability coverage to National Union did not extinguish its duty to defend.<sup>51</sup>

The court in *American National Fire Insurance Co. v. Hammer Trucking, Inc.*, also strictly construed the language of an excess policy, which provided that “[w]e will indemnify the ‘Insured’ for those sums *in excess of* ‘underlying insurance’ or the retained limit that the ‘Insured’ becomes *legally obligated to pay as damages* because of ‘injury’ caused by an ‘occurrence’ to which this policy applies.”<sup>52</sup> As a result of an auto accident caused by its employee, the insured was found jointly and severally liable with the employee for damages in excess of \$3 million.<sup>53</sup> However, after the judgment was rendered, the insured and others entered into a settlement agreement with the injured plaintiff, whereby the insured’s primary insurer paid \$1.9 million, a sum in excess of its policy limits, in exchange for a release of its insured’s obligations under the judgment.<sup>54</sup> The insured later filed suit against its excess insurer for breach of contract, claiming that the excess insurer was required to indemnify it for the amount of the judgment that exceeded the underlying

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<sup>48</sup> *Id.* at 779-83 (emphasis in original) (citing with approval *U.S. Fire Ins. Co. v. Lay*, 577 F.2d 421, 423 (7th Cir. 1978) (holding that excess insurer’s liability was extinguished by settlement agreement between tort claimant and primary insurer for less than the primary policy limits because the agreement released the primary insurer from all liability in excess of \$70,000, so the excess insurer’s indemnity obligation “never arose”); and *Johnson v. Milgo Indus., Inc.*, 458 F. Supp. 297, 301-302 & fn. 3 (D.C. Minn. 1978) (noting that *Zeig* interpreted the term “exhausted” in an ambiguous context and that recent courts have rejected its reasoning; thus, where policy language is unambiguous, courts should apply the plain meaning of the language)).

<sup>49</sup> 646 S.E.2d 682, 686-87 (Ga. App. 2007).

<sup>50</sup> *Id.*

<sup>51</sup> *Id.* at 687.

<sup>52</sup> No. 2-04-327-CV, 2006 WL 3247906, \*3 (Tex. App. Nov. 9, 2006) (not reported in S.W.3d) (emphasis in original).

<sup>53</sup> *Id.* at \*1.

<sup>54</sup> *Id.*

policy limits.<sup>55</sup> The court rejected this argument, noting that under the language of the excess policy's indemnity provision, the excess insurer "had a duty to indemnify its insured for the amount in 'excess' of any underlying policy that its insured became 'legally obligated to pay as damages.'"<sup>56</sup> Because the insured was released from liability for the judgment under the settlement agreement, the excess insurer's duty "was never triggered ... because there was no excess for which [the insured] became legally obligated to pay."<sup>57</sup>

And in *GenCorp, Inc. v. AIU Insurance Co.*, following claims for environmental clean-up costs, the insured sought indemnity and defense costs from a number of insurers providing various levels of coverage.<sup>58</sup> The insured settled with several of its insurers for amounts less than the policy limits, following which certain excess insurers moved for summary judgment, claiming that their policies could not possibly be triggered because the combined limits of the insured's primary policies exceeded the insured's own estimate of liability at the sites.<sup>59</sup> The insured countered that, even though it had settled for an amount less than the policy limits, it could reach its excess liability coverage by allocating all of its liability during a particular policy period to just one primary policy, requiring the excess insurers for that period to cover its additional liability.<sup>60</sup> The court concluded that by settling with some of the insurers, the insured chose to allocate its liability as broadly as it could and found that it would be inequitable to require the excess insurers to step forward to provide coverage for which they would not otherwise have been liable, particularly where the insured's settlements precluded any possibility of seeking contribution from the other insurers.<sup>61</sup> Accordingly, the court granted summary judgment in favor of the excess insurers.<sup>62</sup>

### III. PUBLIC POLICY ARGUMENTS

Courts following both lines of exhaustion cases have put forward public policy arguments in support of their decisions. In *Zeig*, Judge Augustus N. Hand wrote that "the excess insurer has 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 the policies."<sup>63</sup> Following this reasoning, other courts have found that the public interest in fostering

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<sup>55</sup> *Id.*

<sup>56</sup> *Id.* at \*3.

<sup>57</sup> *Id.* Note that a similar argument was rejected by the court in *Twin City Fire Insurance Co., Inc. v. Ohio Casualty Insurance Co., Inc.*, 480 F.3d 1254, 1260-61 (11th Cir. 2007), where the settlement agreement released the insured but reserved the claimant's right to pursue recovery from the insured's insurers.

<sup>58</sup> 297 F. Supp. 2d 995, 997 (N.D. Ohio 2003).

<sup>59</sup> *Id.* at 997-1000.

<sup>60</sup> *Id.* at 1000.

<sup>61</sup> *Id.* at 1007-08.

<sup>62</sup> *Id.* at 1008. On appeal, the Sixth Circuit affirmed. *GenCorp Inc. v. AIU Ins. Co.*, 04-3244, 2005 WL 1607035 (6th Cir. Aug. 7, 2005), 138 Fed. Appx. 732.

<sup>63</sup> *Zeig v. Massachusetts Bonding & Insurance Co.*, 23 F.2d 665, 666 (2d Cir. 1928).

settlement supports a loose interpretation of policy language to permit an insured to establish exhaustion through settlement for less than the policy limits. For example, in *Archer Daniels Midland v. Aon Risk Services, Inc. of Minnesota*, the court opined:

[The insured's] approach makes sense, while [the excess insurer's] proposed rule defies public policy. Under [a strict construction of the policy language requiring payment], insureds with losses exceeding the limits of their primary coverage never would settle with their primary and lower layer carriers, because they automatically would lose their excess coverage. Such a bar on negotiated settlements would place enormous burdens on insureds (or third-party claimants), primary and other underlying insurers, and the courts, without remedying any prejudice to excess carriers.<sup>64</sup>

Other courts have found that public policy supports a strict construction of the policy language, requiring payment to establish exhaustion. In *United States Fire Insurance Co. v. Lay*, the Seventh Circuit considered a situation in which the insured and primary insurer negotiated a release with a third party claimant pursuant to which the primary insurer paid \$70,000 of its \$100,000 limits.<sup>65</sup> The claimant then instituted a wrongful death action, and the parties agreed to a judgment in the amount of \$150,000 solely against the insured's insurers, with the primary insurer receiving a credit for its policy limits of \$100,000.<sup>66</sup> The excess insurer, whose policy provided coverage for loss the insured or primary insurer became "legally obligated to pay as damages" in excess of the underlying limit, sought a declaration that it had no liability for the judgment.<sup>67</sup> Finding in favor of the excess insurer, the *Lay* court explained:

We can conceive of good reasons for an excess carrier to be unwilling to accept liability unless the amount of the primary policy has actually been paid. A settlement for less than the primary limit that imposed liability on the excess carrier would remove the incentive of the primary insurer to defend in good faith or to discharge its duty ... to represent the interests of the excess carrier. Here the primary insurer had no incentive whatsoever to reach a settlement at a figure between \$70,000 and \$100,000. Moreover, the settlement agreement terminating [the insured's] liability of the [claimant] made her subsequent wrongful death action against [the insured] a sham. Neither [the insured] nor the primary insurer, which purported to defend the action, had any interest whatsoever in the outcome.<sup>68</sup>

The argument has also been made that insureds have no incentive to collude with primary insurers because the insured is required to "bridge the gap" between the settlement amount and

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<sup>64</sup> CIV. 97-2185JRTRLE, 1999 WL 34818933, \*5 (D. Minn. February 25, 1999) (not published in F. Supp.).

<sup>65</sup> 577 F.2d 421, 422 (7th Cir. 1978).

<sup>66</sup> *Id.*

<sup>67</sup> *Id.*

<sup>68</sup> *Id.* at 423 (citing *Burkett v. Crulo Trucking Company, Inc.*, 355 N.E.2d 253 (Ind. App. 1976); *Estate of Penn v. Amalgamated Gen. Agencies*, 148 N.J.Super. 419, 372 A.2d 1124, 1127 (1977)).

the primary policy limits.<sup>69</sup> However, this position assumes that the underlying claim is meritorious.

An insured with a claim that is questionable in terms of coverage or damage calculation likely will have a great deal of incentive to settle with the underlying carriers rather than receive an adverse judgment that cuts off all potential to reach excess insurance. In so doing, the settling insured defeats one of the principal advantages that allows carriers to offer excess coverage for much lower rates than comparable primary insurance – that the primary insurance acts as a buffer or a filter for claims of questionable merit.<sup>70</sup>

When policy language is clear and explicit, courts simply should not use public policy arguments to override the policy language.<sup>71</sup> Not only is such action inequitable, but it also runs contrary to public policy concerns that support the excess insurers' position. Like all insurers, excess insurers undertake a particular risk in exchange for a particular premium. Uncertainty in the extent of the insurers' obligations will inevitably lead to an increase in the cost of insurance and potentially make it more difficult for insureds to obtain insurance.

Finally, even in non-payment exhaustion clause cases, the argument exists that settlement with the primary insurer does nothing to lessen or minimize litigation because the case (and the prospect of trial on close to the same scale as the original case) still exists.

Indeed, the policyholder's settlement with some of its underlying insurers, without settlement with one or more excess insurers, does not advance the public interest in promoting settlement of disputes because the policyholder still must litigate its claim against the nonsettled excess insurers, who in all likelihood have the same or similar coverage defenses as those of the settling insurers, with the nonsettling insurer also having a defense that the underlying coverage is not exhausted.<sup>72</sup>

#### IV. CONCLUSION

Determining whether exhaustion has occurred depends in large part on policy language, as well as on the law applied by the deciding court. Accordingly, excess fidelity insurers should

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<sup>69</sup> See Lisa M. LeNay, Michele L. Fenice, and Rebecca B. Howald, *I'm Exhausted! Recent Case Law on the Exhaustion of Underlying Policy Limits and the Burgeoning Challenges that Co-Insurers and Co-Sureties Face When Settling a Multi-Insurer Claim*, presented at the ABA Fidelity and Surety Law Committee Mid-Winter Meeting, January 2009 (citing *Archer Daniels Midland v. Aon Risk Servs., Inc. of Minnesota*, CIV. 97-2185JRTRLE, 1999 WL 34818933, \*4 (D. Minn. February 25, 1999) (not published in F. Supp.)).

<sup>70</sup> *Id.*

<sup>71</sup> See, e.g., *Comerica Inc. v. Zurich Am. Ins. Co.*, 498 F. Supp. 2d 1019, 1029-32 (E.D. Mich. 2007); *Qualcomm, Inc. v. Certain Underwriters At Lloyd's, London*, 161 Cal. App. 4th 184, 73 Cal. Rptr. 3d 770, 785-86 (Cal. App. 2008).

<sup>72</sup> See John F. O'Connor, *Insurance Coverage Settlements and the Rights of Excess Insurers*, 62 MD. L. REV. 30, 77 and n. 250 (2003).

review their policy language and research the law of the appropriate jurisdiction before making any decision to deny or pay a claim.