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## **LOOK OUT BELOW: EXCESS INSURERS ARGUE THAT SETTLEMENT WITH AN UNDERLYING INSURER NEGATES EXCESS COVERAGE**

*by Richard Shore, Stephen A. Weisbrod, and Andrea K. Hopkins*

Most companies and other policyholders with significant insurance needs purchase coverage in layers. Policyholders reasonably assume that excess insurers are obligated to pay if and when the policyholder's liability exceeds any applicable liability limits of the underlying primary and excess coverage. Courts across the country have so ruled in cases stretching back more than 80 years.

But in a number of recent intermediate appellate court cases, including *Comerica*<sup>1</sup> in 2007 and *Qualcomm*<sup>2</sup> in 2008, insurers successfully have argued that certain language in some excess policies negates coverage if underlying insurers do not pay the full amount of applicable underlying liability limits, even if the policyholder's total liability exceeds the underlying limits. Where the policyholder settles with underlying insurers for less than applicable limits, absorbs the shortfall itself, and then turns to overlying excess insurers for coverage of amounts exceeding the underlying limits, excess insurers argue that they owe nothing. Insurers assert that the same result applies where an underlying insurer fails to pay full limits for any other reason, including insolvency or other financial impairment – situations that may become more common given the current economic downturn.

The *Comerica* and *Qualcomm* holdings have been widely criticized, and for good reason. They flout long-established precedent, ignore relevant policy language, defeat policyholders' reasonable expectations of coverage, contravene important public policies, including those favoring settlement, and confer an unjustified

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<sup>1</sup> *Comerica Inc. v. Zurich Am. Ins. Co.*, 498 F. Supp. 2d 1019 (E.D. Mich. 2007).

<sup>2</sup> *Qualcomm, Inc. v. Certain Underwriters At Lloyds, London*, 161 Cal. App. 4th 184, 73 Cal. Rptr. 3d 770 (Cal. Ct. App. 2008).

windfall on excess insurers. Ironically, by discouraging compromise, the holdings may result in insurers being compelled to litigate cases they would rather settle, thus undercutting their broader interests.

Although there is more than ample reason to disagree with the recent cases, policyholders should reject language in any new or renewal policies like that at issue in *Comerica* and *Qualcomm*. Policyholders with coverage claims implicating existing policies should carefully review all potentially applicable excess policies to determine whether they contain such language and factor that into the decision whether and under what circumstances to settle with underlying insurers. If the language is present, settling with underlying insurers may be problematic, unless the jurisdiction whose law applies clearly has rejected the holdings of *Comerica* and *Qualcomm*, the settlements are made contingent on the policyholder's also reaching acceptable settlements with excess insurers whose policies include the problematic language, or the policyholder takes other steps to avoid the arguments of excess insurers seeking forfeiture windfalls.

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#### **ZEIG AND ITS PROGENY**

For at least 80 years, beginning with the Second Circuit decision in *Zeig* in 1928,<sup>3</sup> courts across the country have held that a settlement between a policyholder and an insurer for less than any applicable limit of liability does not result in a forfeiture of overlying excess coverage, as long as the policyholder's liability exceeds the applicable underlying coverage limits.<sup>4</sup> In *Zeig*, the Second Circuit rejected the argument that a policyholder could not collect excess insurance unless the primary insurer paid the full limits of the primary policy, finding that result "unnecessarily stringent."<sup>5</sup> The Second Circuit concluded that the excess insurer "had no rational interest in whether the insured collected the full amount of the primary policies, so long as it [the excess insurer] was only called upon to pay such portion of the loss as was in excess of the limits of those policies."<sup>6</sup> An excess insurer issues a policy expecting to pay when the policyholder's liability reaches a certain threshold. From the standpoint of the excess insurer, it makes no difference whether the policyholder or the underlying insurers pay amounts below that threshold.

Since *Zeig*, most courts across the country have agreed that an excess insurer is not relieved of liability where the policyholder settles with an underlying insurer for less than any applicable limits of the underlying insurance.<sup>7</sup> For example, the Delaware Superior Court recently held that where the policyholder "filled the

<sup>3</sup> *Zeig v. Mass. Bonding & Ins. Co.*, 23 F.2d 665 (2d Cir. 1928).

<sup>4</sup> Appellant's Opening Brief at \*2, *Qualcomm, Inc. v. Certain Underwriters At Lloyds, London*, 161 Cal. App. 4th 184, 73 Cal. Rptr. 3d 770 (Cal. Ct. App. 2008) (No. D050433), 2007 WL 2322132.

<sup>5</sup> *Zeig*, 23 F.2d at 666 ("We can see no reason for a construction so burdensome to the insured").

<sup>6</sup> *Id.*

<sup>7</sup> See e.g., *Pereira v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, No. 04 Civ. 1134 (LTS), 2006 WL 1982789, at \*7 (S.D.N.Y. July 12, 2006); *Elliott Co. v. Liberty Mut. Ins. Co.*, 434 F. Supp. 2d 483, 499-500 (N.D. Ohio 2006); *St. Paul Surplus Lines Ins. Co. v. Life*

gap” by paying the difference between the amount of the insurance settlement and the primary policy limit, the excess coverage was triggered.<sup>8</sup> Cases following *Zeig* sensibly find that the relevant inquiry for the trigger of excess coverage is whether the policyholder’s liability exceeds the amount of underlying coverage.<sup>9</sup>

### ***COMERICA AND QUALCOMM***

*Comerica* and *Qualcomm* reached the contrary conclusion. These cases hold that, where an excess policy allegedly provides that excess coverage is not triggered until the underlying insurer has paid or been held liable to pay its full policy limit, excess coverage is forfeited if the policyholder settles with an underlying insurer for less than any applicable underlying limits, even if the policyholder’s total liability exceeds those underlying limits.<sup>10</sup> The conclusion reached in these cases is deeply flawed for several reasons, including those discussed below.

### ***COMERICA AND QUALCOMM CONTRAVENE BLACK-LETTER CONTRACT LAW***

A central flaw in the *Comerica* and *Qualcomm* decisions is that, at best for the insurers, the alleged requirement that the primary insurer actually pay the full amount of the primary policy is a non-material aspect of the excess insurance contract. It is a fundamental tenet of contract law – and common sense – that the alleged breach of a non-material term of a contract does not relieve the other party of its contractual obligations. Here, it is as if a policy specified that claims be submitted in Arial font and the insurer argued it was relieved of its coverage obligations for a claim submitted in Times New Roman font. In fact, the Delaware Superior Court in *HLTH* interpreted policy language similar to the language at issue in *Qualcomm*<sup>11</sup> and held that “the excess insurance

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*Fitness*, No. C3-99-9980, 2001 WL 588949, at \*3-4 (D. Minn. Jan. 29, 2001); *Kelley Co., Inc. v. Cent. Nat’l Ins. Co. of Omaha*, 662 F. Supp. 1284, 1288-90 (E.D. Wis. 1987); *Siligato v. Welch*, 607 F. Supp. 743, 746-47 (D. Conn. 1985); *Home Indem. Co. v. Mission Ins. Co.*, 251 Cal. App. 2d 942, 965-66, 60 Cal. Rptr. 544, 561-62 (Cal. Ct. App. 1967); *Reliance Ins. Co. v. Transamerica Ins. Co.*, 826 So. 2d 998, 999-1001 (Fla. Dist. Ct. App. 2001); *Futch v. Fid. & Cas. Co. of N.Y.*, 166 So. 2d 274, 278 (La. 1964); *Weaver v. Kitchens*, 570 So. 2d 508, 510 (La. Ct. App. 1990); *Drake v. Ryan*, 514 N.W.2d 785, 789-90 (Minn. 1994); *Rummel v. Lexington Ins. Co.*, 945 P.2d 970, 977-79 (N.M. 1997); *Teigen v. Jelco of Wis., Inc.*, 367 N.W.2d 806, 810 (Wis. 1985)).

<sup>8</sup> *HLTH Corp. v. Agric. Excess & Surplus Ins. Co.*, C.A. No. 07C-09-102 RRC, 2008 WL 3413327 (Del. Super. Ct. July 31, 2008).

<sup>9</sup> See *supra* note 8.

<sup>10</sup> *Comerica*, 498 F. Supp. 2d 1019; *Qualcomm*, 161 Cal. App. 4th 184, 73 Cal. Rptr. 3d 770. Among other things, the language at issue in *Comerica* provided that “[i]n 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,” *Comerica*, 498 F. Supp. 2d at 1022, and the language at issue in *Qualcomm* provided that “[u]nderwriters 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,” *Qualcomm*, 161 Cal. App. 4th at 189, 73 Cal. Rptr. 3d at 774.

<sup>11</sup> The *HLTH* policy stated: “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 . . . The risk of uncollectability of any Underlying Insurance . . . is expressly retained by the Insureds.” *HLTH*, 2008 WL 3413327, at \*14.

company could not possibly claim to have a stake in whether the insured actually received all of the underlying insurance limits.”<sup>12</sup> Despite policy language that the insurer argued required actual payment by the underlying insurers, the *HLTH* court found that the “[d]efendants’ liability is completely unchanged whether Plaintiffs have received all of the underlying payments or not,” and expressly declined to follow *Qualcomm* and *Comerica*.<sup>13</sup> The court accordingly rejected the insurer’s position that it be relieved of its contractual obligations based on the amount of the underlying insurer’s payment.

### ***COMERICA AND QUALCOMM VIOLATE POLICYHOLDERS’ REASONABLE EXPECTATIONS OF COVERAGE***

The *Qualcomm* and *Comerica* cases also disturb the expectations of the parties to the insurance contracts and award undeserved windfalls to excess insurers. A fundamental principle of insurance law is that insurance policies should be construed to uphold the reasonable expectations of the insured.<sup>14</sup> It is eminently reasonable for a policyholder to expect that its insurers will cover liabilities that exceed the underlying policy limits, regardless whether the underlying insurers actually pay those amounts. Indeed, relevant policy language supports that expectation.<sup>15</sup> And it is patently unreasonable for an insurer to argue that it is entitled to escape its coverage obligations, for which it received a valuable premium, based on the underlying insurers’ failure to pay their full limits, when that failure has no impact on the non-settling insurer. Moreover, under the 80-year precedent established by the *Zeig* line of cases, no excess insurer could have expected that a policyholder would forfeit excess coverage by settling with its primary insurer for less than the full policy limits while absorbing the difference between the settlement amount and the policy limit.

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<sup>12</sup> *Id.* (citing *Westinghouse Elec. Corp. v. Am. Home Assurance Co.*, Nos. A-6706-01T5, A-6720-01T5, 2004 WL 1878764 (N.J. Super. Ct. App. Div. July 8, 2004)).

<sup>13</sup> *Id.* at \*15.

<sup>14</sup> *See, e.g.*, 2 COUCH ON INS. § 21:4 (3d ed. 2008) (“Judges need not check their common sense at the door when interpreting insurance policies and the plain language within them; relevant terms and provisions are not to be construed in a vacuum and the terms must be read in conjunction with the insured’s reasonable expectations, the public policy behind the provisions, and the intended coverage of those provisions.”).

<sup>15</sup> In the *Rummell* case, for example, the New Mexico Supreme Court noted that the policy at issue, like the policy in *Qualcomm*, provided that the excess insurer would pay when the underlying insurance “has paid or has been held liable to pay the total applicable underlying limits,” and also defined “loss” to include amounts owed by underlying insurers “whether recoverable or not.” *Rummell v. Lexington Ins. Co.*, 945 P.2d 970, 977-78 (N.M. 1997) (emphasis added). The court concluded that this language contemplated payment by the excess insurer as long as the policyholder’s liability exceeded the underlying limits, notwithstanding the underlying insurers’ inability or refusal to pay the full amount of the underlying limits or the policyholder’s settlement with underlying insurers for less than their applicable limits. *Id.* at 977-79.

## PUBLIC POLICY CONSIDERATIONS FAVOR *ZEIG* AND ITS PROGENY

### *Public Policy Favoring Settlements*

The *Zeig* line of cases is supported by logic and public policy. Perhaps the most significant of these policy concerns is the impact of *Qualcomm* and *Comerica* on the ability of policyholders and insurers to reach settlement agreements. The *Zeig* court found that “[t]o 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.”<sup>16</sup> The *HLTH* court also noted that “[s]ettlements avoid costly and needless delays and are desirable alternatives to litigation where both parties can agree to payment and leave other separately underwritten risks unchanged.”<sup>17</sup> The *Qualcomm* and *Comerica* decisions may compel policyholders to litigate when they and their insurers would rather settle, since settlement exposes them to arguments that excess coverage is forfeit. This is unfortunate not only for policyholders, but also for courts, and potentially for the tort victims in the underlying cases.<sup>18</sup> And although it may benefit particular insurers in specific cases, it contradicts insurers’ more general interest in being able to settle coverage disputes and thus mitigate litigation risk.

### *Public Policy Against Forfeitures*

The *Qualcomm* and *Comerica* decisions upset policy considerations recognized by several states that disfavor forfeitures of insurance rights.<sup>19</sup> Requiring underlying insurers to pay applicable limits, rather than considering whether the policyholder’s liability exceeds the amount of those limits, arbitrarily deprives policyholders of valuable insurance coverage for which they have paid substantial premiums and on which they have relied to protect themselves from liability exceeding the amount of underlying coverage.<sup>20</sup>

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<sup>16</sup> *Zeig*, 23 F.2d at 666.

<sup>17</sup> *HLTH*, 2008 WL 3413327, at \*15.

<sup>18</sup> Appellant’s Opening Brief at \*2-3, *Qualcomm*, *supra* note 5.

<sup>19</sup> *See, e.g., ABI, Inc. v. Los Angeles*, 153 Cal. App. 3d 669, 681, 200 Cal. Rptr. 563, 570 (Cal. Ct. App. 1984) (“The public policy of the state militates strongly against forfeiture”); *James v. Pa. Gen. Ins. Co.*, 167 Ga. App. 427, 430, 306 S.E.2d 422, 425 (Ga. Ct. App. 1983) (same); *Campbell v. Norfolk & Dedham Mut. Fire Ins. Co.*, 682 A.2d 933, 935 (R.I. 1996) (same); *Asbury v. Ind. Union Mut. Ins. Co.*, 441 N.E.2d 232, 242 (Ind. Ct. App. 1982) (same); *Phico Ins. Co. v. Providers Ins. Co.*, 888 F.2d 663, 669 (10th Cir. 1989) (same).

<sup>20</sup> *See* Appellant’s Opening Brief at \*3, *Qualcomm*, *supra* note 5. Qualcomm incurred \$30 million in liabilities, settled with its primary insurer for \$16 million, and agreed to bear the next \$4 million itself to reach the \$20 million primary policy limit. *Id.* Qualcomm’s excess insurance provided an additional \$20 million in coverage. *Id.* at 5. The court’s decision that the excess policy was not triggered, thus, left Qualcomm to pay the remaining \$10 million in liabilities. *Id.*

### ***Public Policy Respecting Mutuality of Obligations***

To the extent that an excess insurer has denied coverage (or reserved rights to deny coverage) on other grounds, applying the result of *Qualcomm* and *Comerica* also would violate the fundamental principle that an insurer in breach of its coverage obligations cannot insist on the policyholder's compliance with all of the alleged terms of the policy. As Justice Holmes wrote more than 100 years ago in *St. Louis Dressed Beef*, one of the few insurance coverage cases to reach the U.S. Supreme Court:

[W]hen one party, by his fault, prevents the other party to a contract from entitling himself to a benefit under it according to its terms, the former is liable for the value of that benefit . . . Moreover, the [insurer], by its refusal, cut at the very root of the mutual obligation, and put an end to its right to demand further compliance with the supposed term of the contract on the other side.<sup>21</sup>

The non-settling insurer in *Comerica*, for example, denied coverage on multiple grounds.<sup>22</sup> To the extent the grounds were invalid, the non-settling insurer breached its coverage obligations and should not have been permitted to insist that the policyholder forego settlements with other insurers based on the underlying exhaustion language of a policy that it had failed to honor.

### **UNDERLYING INSURER INSOLVENCY: A SPECIAL CONCERN**

Excess insurers argue that policyholders can avoid the draconian consequences of *Qualcomm* and *Comerica* by refraining from settling with underlying insurers for less than underlying limits. But, in some instances, events beyond a policyholder's control may result in the underlying insurer's failure to pay full limits. In particular, the underlying insurer may become insolvent. There is a long history of courts holding that the insolvency of a lower-layer insurer will not excuse the payment obligations of an upper-layer insurer.<sup>23</sup> Insurers have argued,

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<sup>21</sup> *St. Louis Dressed Beef & Provision Co. v. Md. Cas. Co.*, 201 U.S. 173, 181 (1906); see also, e.g., *Cay Divers, Inc. v. Raven*, 812 F.2d 866, 870 (3d Cir. 1987); *Luria Bros. & Co., Inc. v. Alliance Assurance Co.*, 780 F.2d 1082, 1092 (2d Cir. 1986); *Mass. Bonding & Ins. Co. v. Car & Gen. Ins. Corp.*, 152 F. Supp. 477, 480 (E.D. Pa. 1957); *United Servs. Auto. Ass'n v. Morris*, 154 Ariz. 113, 119, 741 P.2d 246, 252 (Ariz. 1987); *Isadore Rosen & Sons, Inc. v. Sec. Mut. Ins. Co. of N.Y.*, 31 N.Y.2d 342, 347, 291 N.E.2d 380, 382 (N.Y. 1972); *Ford v. State Farm Mut. Auto. Ins. Co.*, 550 S.W.2d 663, 665-66 (Tex. 1977).

<sup>22</sup> See *Comerica*, 498 F. Supp. 2d at 1020 (the insurer "disputed coverage on at least some of the claims on various grounds").

<sup>23</sup> See, e.g., *U.S. Fid. & Guar. Co. v. Treadwell Corp.*, 58 F. Supp. 2d 77, 88 n. 11 (S.D.N.Y. 1999) (quoting *Zeig* and finding that although "an excess insurer is not required to drop down to provide coverage merely because the underlying primary insurer is insolvent . . . Nevertheless, the excess policy is triggered when aggregate payments by the primary insurer, and by the insured in lieu of the insolvent primary insurer, exceed the underlying policy's liability limits."); *Polygon Northwest Co v. Am. Nat'l Fire Ins. Co.*, 143 Wash. App. 753, 771-73, 189 P.3d 777, 786-88 (Wash. Ct. App. 2008) (requiring the excess insurers to pay under policies providing coverage in excess of the underlying "limits of insurance" where the underlying insurer became insolvent); see also *Hartford Accident & Indem. Co. v. Chicago Hous. Auth.*, 12 F.3d 92, 96 (7th Cir. 1993) (same); *Huggins v. Gerry Lane Enters., Inc.*, 957 So. 2d 127, 131 (La. 2007) (same).

however, that, regardless of the reason the underlying insurer does not pay its full applicable limits, overlying excess insurers may be relieved of their coverage obligations under *Comerica* and *Qualcomm*. Those cases are of particular concern now, given predictions that the ongoing economic slowdown may result in increasing insurer insolvencies.

## CONCLUSION

Although the *Qualcomm* and *Comerica* cases are fundamentally flawed, policyholders should not assume that they can settle with underlying insurers for less than the amount of any applicable underlying limits without putting excess coverage at risk. Policyholders with pending claims must carefully review their policies for the problematic exhaustion language, and should consult coverage counsel before considering settlement. Policyholders seeking new or renewal policies should reject the language found to be problematic in *Comerica* and *Qualcomm*.

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