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Excess Policies at Issue Deemed Not to Attach Absent Actual Payment of the Amount of Underlying Limits by Either the Insured or its Underlying Insurers

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Policyholders contemplating insurance coverage settlements with low-level insurers should use caution to preserve their ability to access higher-level excess policies. Excess insurers are increasingly disputing that underlying policies are properly exhausted where policyholders elect to settle with underlying insurers for less than full limits. The issue can be further complicated if the policyholder seeks protection under the bankruptcy laws against long-tail liabilities, as a recent case illustrates.

The U.S. Bankruptcy Court for the Southern District of New York, applying New York law, recently rejected a bankrupt policyholder's attempt to access certain excess policies in the absence of full payment of underlying limits in *Rapid-American Corp. v. Travelers Casualty and Surety Co.*, No. 15-01095 (Bankr. S.D.N.Y. June 7, 2016). In so holding, the court declined to expand the "*Zeig* doctrine," derived from *Zeig v. Massachusetts Bonding & Insurance Co.*, 23 F.2d 665, 666 (2d Cir. 1928), which stands for the proposition that an excess insurer has no rational interest in whether the policyholder actually collects full limits from underlying insurers since the excess insurer is only being asked to pay amounts exceeding its attachment point. While the *Rapid-American* decision will not be embraced by the policyholder bar, it must be interpreted in light of the unique factual circumstances and the policyholder's concessions regarding the so-called "exhaustion" requirement in the policies.

In *Rapid-American*, the bankrupt policyholder commenced a Chapter 11 bankruptcy action with approximately 275,000 asbestos claims pending against it and then commenced an adversary proceeding seeking a declaration of its rights to coverage for those asbestos claims under certain excess policies. The policyholder had settled with numerous underlying insurers for less than full limits long before commencing the bankruptcy proceedings. The bankrupt policyholder and creditors committees argued that the excess policies at issue attached by virtue of the fact that the policyholder accrued liability to asbestos claimants in excess of the underlying limits even though neither the policyholder nor its underlying insurers actually paid the full amount of the underlying limits to resolve the asbestos claims. The excess insurers balked on the basis of, *inter alia*, limits of liability language incorporated into a St. Paul policy providing that the excess policies "shall not attach until the amount of the applicable underlying limit has been *paid by or on behalf of the Insured* …." Op. at 5.[1]

[1] Although only one of the three policies at issue actually incorporated this language, the policyholder conceded at oral argument that the other two policies issued by National Union "require exhaustion of underlying insurance similar to the St. Paul Policy" language quoted above. Op. at 10.

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According to the insurers, by failing to pay the full amount of the underlying limits to resolve asbestos liabilities, the policyholder failed to satisfy the limit of liability provision.

In considering the competing motions for summary judgment that framed the issues, the court assumed that the policyholder's accrued asbestos liabilities were sufficient to reach the excess policies, and no party disputed that neither Rapid American nor its underlying insurers had actually paid amounts in judgments or settlements equal to the underlying limits of liability. Seeking to get around the limits of liability provision, the policyholder argued that: (1) the *Zeig* doctrine mandates that the "exhaustion language" in the limits of liability provision not be read literally and that the underlying policies should be deemed to be exhausted if the policyholder settles with and releases the underlying insurers, (2) the bankruptcy clause and New York insurance law preclude the insurers from relying on the "exhaustion language" because bankruptcy precludes the policyholder from filling the gap and paying up to the underlying limits, and (3) the maintenance clauses prevent the Insurers from requiring exhaustion of underlying insurance.

Regarding the *Zeig* doctrine, the court questioned its viability in light of a 2013 decision by the Second Circuit Court of Appeals in *Ali v. Federal Ins. Co.*, 719 F.3d 83 (2d Cir. 2013), which declined to apply *Zeig* in a third-party liability context because, unlike *Zeig*, which involved first-party coverage under a theft policy, a policyholder attempting to trigger third-party liability policies "might be tempted to structure inflated settlements that would have the same effect of requiring the excess insurers to 'drop down' and assume coverage in place of insolvent carriers." Op. at 20, *citing Ali*, 719 F.3d at 94. The court was also persuaded by *Forest Labs., Inc. v. Arch Ina. Co.*, 953 N.Y.S.2d 460 (N.Y. Sup. 2012), *aff'd* 984 N.Y.S.2d 361 (N.Y. App. Div. 2014), which the *Rapid American* court understood as holding that the rationale of *Zeig* should not override express language in a third-party policy requiring exhaustion of underlying limits by actual payment. Op. at 20-21. Based largely on the concern that a policyholder could be incentivized to collude with underlying claimants to trigger excess coverage, the *Rapid American* court declined to apply the *Zeig* doctrine.

The policyholder's arguments regarding the bankruptcy clauses and similar New York insurance law requirements also did not convince the court. The bankruptcy clauses and the New York insurance code generally provide that "bankruptcy or insolvency of the Insured … shall not relieve the [insurer] of any of its obligations" to provide coverage. The court observed that these clauses were designed to protect an injured third party, not the policyholder, from the inability of the policyholder to pay a liability due to bankruptcy. The court also distinguished caselaw holding that the inability of a bankrupt policyholder to pay a self-insured retention ("SIR") does not invalidate excess coverage. According to the court, a policyholder is *required* to pay an SIR before excess coverage attaches. The court placed great weight on the contrasting language at issue here, which required only that the amount of underlying insurance be paid "by or on behalf of" the policyholder. Op. at 26.

The court also rejected the policyholder's arguments that the maintenance clauses in the policies at issue prevent the insurers from requiring payment of the underlying limits. The maintenance clauses generally provide that the policyholder must maintain the underlying policies during the currency of the policy or during the policy period, but the failure of the policyholder to do so does not invalidate the excess coverage. The clauses further provide that the excess insurer shall be liable only to the extent that it would have been liable had the policyholder maintained the underlying coverage. The court held that a settlement with an underlying insurer does not constitute a failure to maintain underlying insurance and does

not excuse the policyholder from complying with the limits of liability language requiring payment "by or on behalf of the insured." Op. at p. 23.

Accordingly, the court held that the excess policies at issue unambiguously require actual payment of underlying limits before coverage attaches. This decision of a New York bankruptcy court, however, must be read on the context of the specific factual context and the policyholder's concession that all of the policies at issue require exhaustion similar to the St. Paul policy at issue, which stated that the excess policy would attach only after payment "by or on behalf of the policyholder." Even with the ruling of *Rapid American*, in most instances, the policyholder should still be permitted to fill the gap between a settlement with an underlying insurer and an excess policy's attachment point by paying the delta itself.

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