ALERT
JUNE 25, 2012

GLOBAL INSURANCE GROUP
News Concerning
Recent Professional Liability Issues

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Maximus Opinion Permits Functional Exhaustion of Underlying Insurance

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Excess insurers should carefully note both trends in the law, and particular policy language, that may potentially influence whether their policyholders can exhaust underlying policies *without* actually receiving payment of the full underlying limits. In its recent opinion in *Maximus, Inc. v. Twin City Fire Insurance Company*, No. 11-CV-1231, the U.S. District Court for the Western District of Virginia determined that an ambiguously worded follow-form excess policy permitted this result.

Policyholders seeking their full insurance limit from one or more underlying insurers for an expensive loss may decide to avoid risk, by entering into below-limits settlements with those insurers. After "filling the gap," by paying the difference between the below-limit settlement amount and the full underlying policy limit toward the loss, the policyholder may then call on its excess insurer and claim "functional exhaustion" of the underlying layer(s).

The *Maximus* court ruled that ambiguous language appearing in the third-excess professional liability insurance policy issued by Axis Reinsurance Company (Axis) permitted the insured (Maximus, Inc.) to exhaust the policy limits of all three underlying policies below Axis by (1) settling its coverage claims with each underlying insurer and (2) "filling the gap" by paying the difference between what each underlying insurer paid and the insurer's policy limit.

Maximus was involved in an underlying breach of contract lawsuit, arising from its provision of health and human services programs in the State of Texas. Maximus claimed coverage for total damages of $78.3 million based on the underlying settlement agreement.[1] Addressing the terms of Axis's excess coverage for damages in the $60 to $70 million range, the court found that Maximus had satisfied the Axis policy's underlying-exhaustion requirement.

The *Maximus* court applied Virginia law to conclude that the Axis policy's exhaustion provision was ambiguous and relied on the "public policy favoring settlements" as articulated in the 1928 2nd Circuit case *Zeig v. Massachusetts Bonding & Ins. Co.*, 23 F.2d 665 (2nd Cir. 1928).

According to the *Maximus* court, *Zeig* had concluded that it made no practical difference to an excess insurer whether its exhaustion point was reached by full collection of the underlying policy limits, so long as the excess insurer was only called upon to pay the portion of loss in excess of the underlying limits. And *Zeig* further commented that litigation, delay, and other inconvenience contrary to public policy would result from inhibiting settlements between underlying insurers and policyholders. *Zeig* therefore permitted *functional* exhaustion of an underlying policy, even if the underlying insurer paid *less* than its policy limit, as long as the policyholder paid the remainder of the policy limit toward an underlying loss.

In recent years, many courts have rejected insureds' "functional exhaustion" arguments based on *Zeig*, by enforcing policy language that requires actual payment by the underlying insurer of its full policy limits. Frequently cited examples include *Comerica, Inc. v. Zurich Am. Ins. Co.*,

1 The court indicated it would later address whether Maximus's settlement, which included "$40 million in cash settlement payments" plus additional amounts for "services credits and forgiven invoices," actually involved more than $60 million in proven "damages."

498 F.Supp.2d 1019 (E.D. Mich. 2007), *Qualcomm, Inc. v. Certain Underwriters at Lloyd's, London*, 161 Cal App 4th 184, 73 Cal. Rptr. 3d 770 (Cal. App. 2008); and *Citigroup, Inc. v. Federal Ins. Co.*, 649 F.3d 367 (5th Cir. 2011). The *Comerica* court discussed *Zeig*, but explained that its holding does not apply where the excess policy language clearly specifies that the exhaustion of underlying insurance requires actual payment by the underlying insurer. Interestingly, two different New York courts have made similar comments about *Zeig*'s inapplicability when exhaustion language is clear, just within the past year. *J.P. Morgan Chase & Co. v. Indian Harbor Ins. Co.*, 930 N.Y.S.2d 175 (N.Y. Sup. Ct. May 26, 2011), and *Federal Ins. Co. v. Estate of Irving Gould*, 2011 WL 4552381 (S.D.N.Y., Sept. 28, 2011).

Maximus represents a departure from the recent trend of limiting *Zeig*. The *Maximus* court concluded that Axis could have written its excess policy "so unambiguously as to overcome the public policy concerns" in *Zeig*, but it did not. As a follow-form insurer, Axis issued a "critical provision" stating as follows:

"The insurance afforded under this Policy shall apply only after all applicable underlying Insurance with respect to an Insurance Product has been exhausted by actual payment under such Underlying Insurance …."

The *Maximus* court took issue with the Axis policy's failure to define "actual payment under such Underlying Insurance" and its failure to include language making clear that exhaustion requires the underlying insurers themselves to pay out the full amount of their policies. It found there was an alternative "plausible" construction of "actual payment," that it meant the completion of payment after a "preliminary or hypothetical" agreement to settle, and, therefore, the term "actual payment" was ambiguous under Virginia law.

In the absence of Virginia case law interpreting the exact Axis policy language, the *Maximus* court compared the Axis excess policy language to the policy provisions addressed in various recent cases nationwide. First, the *Maximus* court noted that the policy language at issue in *Comerica* had clearly required payment of loss by the underlying insurers themselves, where the policy language at issue stated "Coverage hereunder shall attach only after all such 'Underlying Insurance' has been reduced or exhausted by payments for losses …," and the excess policy further stated that it would apply to loss, "[i]n the event of the depletion of the limit(s) of liability of 'Underlying Insurance' solely as a result of the actual payment of loss thereunder by the applicable insurers…."

The *Maximus* court also found the policy language addressed in *Qualcomm* and *Citigroup* was "easily distinguishable" from the language in the Axis policy. *Qualcomm* interpreted an exhaustion clause providing for excess liability "…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." *Citigroup* provided that excess coverage attached "after the total amount of the Underlying Limit of Liability has been paid in legal currency by the insurers of the Underlying Insurance as covered loss thereunder."

Based on the recent result in *Maximus*, issued in March 2012, excess insurers may wish to re-examine their policies' underlying-exhaustion language to assess whether they compare favorably to the language addressed in *Comerica* and its progeny. Additionally, excess insurers are always well-advised to consider the specific provisions of any insurance policy to which their own policies follow-form.

To discuss any questions you may have regarding the issues discussed in this alert, or how they may apply to your particular circumstances, please contact Michael D. Handler at 206.808.7839 or mhandler@cozen.com.