

Second Circuit Restricts *Zeig* to First-Party Context, Requiring Actual Payment of Underlying Limits

The U.S. Court of Appeals for the 2nd Circuit recently eliminated the foundation for policyholders' arguments in favor of "functional exhaustion." In *Ali v. Federal Insurance Co.*, No. 11-5000-cv (2d Cir. June 4, 2013), the 2nd Circuit held that functional exhaustion as permitted in the 1928 decision in *Zeig v. Massachusetts Bonding & Ins. Co.*, 23 F.2d 665 (2d Cir. 1928) does not apply to excess liability policies.

The dispute in *Ali* involved claims for coverage by former directors and officers of a bankrupt computer technology company. In addition to a self-insured retention and primary insurance policy, the company maintained eight levels of excess coverage issued by various carriers. At the time that the insureds sought coverage, two of the insurers in the coverage tower were insolvent, representing the first, third, fourth and sixth excess levels.

Federal Insurance Company issued the second and fifth excess insurance policies. Federal filed a declaratory judgment action in the Southern District of New York, seeking a declaration that it was not required to "drop down" to cover indemnity payments below its attachment point. In response, the insureds filed a counterclaim against Federal and a third-party complaint against Travelers Casualty and Surety Company of America. The insureds argued that the obligations of Federal and Travelers – the other solvent excess insurer – were triggered once the insureds' "defense and/or indemnity obligations [exceed] the limits of any insurance policies underlying their respective policies, regardless of whether such amounts have actually been paid by those underlying insurance companies." The district court rejected the insureds' argument and held that exhaustion of underlying insurance requires actual payment of the underlying limits.

The 2nd Circuit affirmed the district court's decision on appeal. The court's holding enforced the language of the Federal and Travelers policies, both of which state that excess coverage attaches once the underlying insurance is exhausted, and exhaustion occurs "solely as a result of payment of losses thereunder." The court explained that "the plain meaning of the phrase 'payment of losses' refers to the actual payment of losses suffered by the directors – not the mere accrual of losses in the form of liability."

The 2nd Circuit rejected the insureds' *Zeig*-based argument that the excess policies were triggered once the total amount of defense and indemnity costs exceeded the underlying limits, regardless whether such amounts were paid. The court noted the "important differences" between *Zeig*, which arose under a property policy, and *Ali*, which involved liability coverage. The court explained that these differences provided excess liability carriers with "good reason to require actual payment up to the attachment points of the relevant policies, thus deterring the possibility of settlement manipulation." The court also noted that *Zeig* arose out of a "freestanding federal common law" that no longer exists. The combination of these two observations by the court should seriously limit, if not eliminate, policyholder reliance on *Zeig* in favor of gap-filling.

Notably, the court stopped short of precluding insureds from all types of gap-filling. Although the court interpreted the policy language to require full payment of the underlying limits, it did not hold, nor did the policy language require, that the payment be made solely by the underlying insurers. Many policies today do, in fact, require payment solely by the insurer. If *Ali* is read to require adherence to the policy language, as it should be, these newer policy requirements likewise should be upheld.

The *Ali* decision significantly undermines *Zeig*'s usefulness as authority for triggering excess liability policies before the underlying policy limits have been fully paid. *Ali* also signals to excess



Deborah M. Minkoff

**Vice Chair,
Global
Insurance
Department**

dminkoff@cozen.com
Phone: (215) 665-2170
Fax: (215) 665-2013



Abby J. Sher

Member

asher@cozen.com
Phone: (215) 665-2761
Fax: (215) 253-6765

Related Practice Areas

- Insurance Coverage
- Professional Liability Insurance Coverage

Industry Sectors

- Insurance

liability insurers how to avoid having their policies triggered by below-limits settlements. In view of this precedent, excess policies should expressly state that the excess coverage attaches solely in the event of payment of losses by the underlying insurer.

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 Deborah M. Minkoff at 215.665.2170 or dminkoff@cozen.com or Abby J. Sher at 215.665. 2761 or asher@cozen.com.