AKO POLICYHOLDER ADVISOR
The Policyholder Law Firm

Volume 9 Number 2 www.andersonkill.com February 2000

Wag the Dog:

How Allocation Determines Recovery for Long-Tail Losses

Finley Harckham
Jeannine Chanes

Allocation is the new battleground in the on-going coverage war between policyholders and their insurance companies. When claims trigger multiple policies, the issue for insurance companies and policyholders alike is less frequently whether the claim is covered, but how the liabilities will be distributed among the triggered policies. Not surprisingly, policyholders advocate allocation methodologies that maximize recovery without prolonged litigation. Insurance companies, on the other hand, argue for methodologies that allow them to reduce the amount they are obligated to pay—or to avoid payment entirely—by shifting the liability to other entities.

Whether the liability ultimately ends up with other insurance companies or the policyholder itself is irrelevant, as long as it is no longer theirs. Allocation is unique among coverage issues in that it aligns insurance companies against each other as often as they are aligned against their policyholders.

Many types of liability potentially trigger multiple policies, including products liability claims, environmental property damage claims and mass toxic tort claims, such as those involving asbestos bodily injury. These claims, where manifestation of injury is typically separated from the causative events by long periods of time, are the so-called "long-tail" claims.

Occurrence-Based Policies Never Expire

Prior to 1986, standard-form comprehensive general liability ("CGL") policies (now known as commercial general liability policies) provided that the insurance company will pay on behalf of the policyholder "all sums which the insured shall become legally obligated to pay as damages" resulting from an occurrence during the policy period. "Occurrence" was typically defined as "an accident …which results in bodily injury or property damage neither expected nor intended from the standpoint of the insured." Since 1986, CGL policies have been offered in two versions, occurrence-based and claims-made. The two types of policy differ principally with respect to the event which triggers coverage.

An occurrence-based policy is triggered when bodily injury or property damage occurs during the policy period, regardless of when it is discovered. This means that occurrence-based policies still provide coverage even after their policy periods end, unless the insurance company has previously paid out its policy limits. In contrast, a claims-made policy is triggered when a claim for bodily injury or property damage is asserted against the policyholder during the policy period. Therefore, no coverage is available under claims-made policies once their policy periods are over.

Trigger of Coverage

As a threshold matter, any discussion of allocation must address how policies are triggered by long-tail liabilities. This is a hotly-contested issue, of course, because only those policies triggered by the loss must respond to the policyholder's liabilities. Trigger of coverage is not the same as scope of coverage. "Trigger" designates which of a policyholder's insurance policies must potentially cover a loss. "Scope" refers to how much of that loss each policy covers. Courts have adopted four trigger theories: continuous, injury-in-fact, exposure and manifestation.

Continuous. Continuous trigger is based on the assumption that damage for long-tail losses is progressive and occurs continuously from the date of first injury, property damage or exposure.

Injury-in-fact. Under the injury-in-fact trigger, a policy is triggered when an injury "in fact" occurred during that policy period. As a practical matter, courts adopting injury-in-fact have generally held that injury "in fact" occurred at all times from first exposure through manifestation.

Exposure. The exposure trigger provides that only those policies in effect at the time of exposure to the harmful substance or condition will apply to any resulting injury or damage. Policies in effect from the time exposure ends through the time the injury or damage manifests itself are not triggered, even though injury or damage may be continuing during that period.

Manifestation. Under the manifestation trigger, discovery or diagnosis of the injury or property damage determines coverage. A manifestation trigger pushes liabilities out of older policies, which generally contain fewer exclusions to coverage. As a result, manifestation is the most pro-insurance company trigger.

Allocation of Indemnity Costs

Whatever trigger theory a court adopts, once multiple policies are implicated, courts are faced with the task of allocating liabilities among the triggered policies. Although courts have used many allocation schemes, most have relied on a variation of one of three approaches: pick and choose, pro rata by time on the risk and weighted allocation based on time on the risk and policy limits.

Pick and Choose. Pick and choose allocation is not really allocation at all. Allocation spreads liabilities among triggered policies on an equitable basis taking into account, among other things, the terms and conditions of the respective policies and public policy considerations. In contrast, the goal of pick and choose is to make the policyholder whole, not to spread liabilities or evaluate the respective obligations of the insurance companies with triggered policies.

Having the right to pick and choose among its triggered policies gives a policyholder many advantages. Pick and choose makes the policyholder whole relatively quickly and with a minimum of litigation. In addition, pick and choose protects the policyholder from having to retain liabilities for years when it was un-insured or under-insured.

Pro Rata by Time on the Risk. Pro rata allocation by time on the risk is favored by many courts because it is easy to understand and apply. The policyholder's total liability is divided by the years triggered and the result is allocated evenly to each policy period—first to the primary policy, then to the umbrella policy, and so on up through the layers of coverage.

Despite its ease of application, straight pro rata allocation has many drawbacks for policyholders. For instance, pro rata allocation can leave the policyholder liable for periods where its policies are missing, where it was uninsured, or where it was under-insured by today's standards. In addition, policyholders in pro rata states have been held responsible for liabilities that would have been allocated to insolvent insurance companies, notwithstanding the fact that the policyholder has millions of dollars in coverage available from solvent companies in other years.

Weighted Allocation. A number of states have adopted some form of a weighted allocation methodology based on a combination of policy limits, time on the risk, risk transferred, and policy layer.

For instance, New Jersey courts allocate based on risk transferred during a particular period and total risk transferred for the liability. Under the New Jersey allocation formula, the percentage of indemnity costs assigned to a given policy period is determined by a fraction whose numerator is the total insurance coverage available in that period, and whose denominator is the total insurance coverage available during all of the triggered policy periods.

Weighted allocation is favorable to policyholders in that it compensates for inflation and for periods where the insurance purchased is insufficient to cover even a pro rata share of the multi-billion dollar liabilities often encountered with long-tail claims. However, policyholders with long-tail claims in weighted allocation jurisdictions must grapple with the same issues regarding insolvencies and other coverage gaps that are at issue with pro rata allocation.

Allocation of Defense Costs

Standard-form primary CGL policies require the insurance company to pay defense costs in addition to policy limits for indemnity costs. Although defense costs are generally allocated among triggered primary policies in the same manner as indemnity costs, this is not always the case.

For instance, New Jersey courts allocate defense costs among primary insurance companies using a variation of their allocation scheme for indemnity costs, but only factoring in the risk transferred in the primary layer, where the duty to defend lies.

Conclusion

Allocation of liabilities for long-tail claims is a complex area of insurance coverage law that is not well-developed in most jurisdictions. With billions of dollars at stake, both policyholders and insurance companies are attacking allocation disputes with the persistence and ferocity that typifies trench warfare. Until courts resolve the issues raised by allocation with some degree of certainty, resolving insurance coverage disputes involving long-tail claims will continue to be a difficult and lengthy process. ■

Finley Harckham is a partner in AKO's New York office. He can be reached at (212) 278-1543 or at **fharckham@andersonkill.com**