

Mitigating Unintended Consequences in the Placement of Casualty Insurance Towers

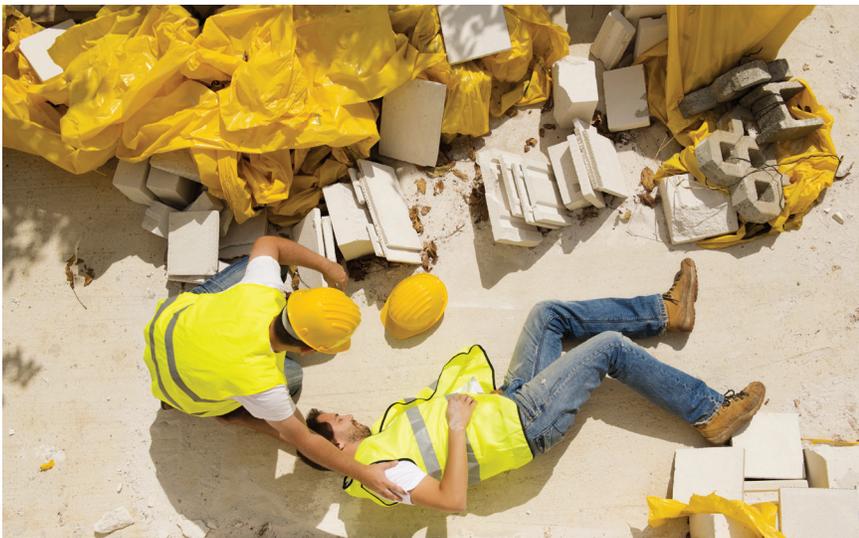


BOARD DISCUSSION

Spotlight on Casualty

Several choices about program structures and policy language can inadvertently affect how insurance policies respond to casualty losses.

Organizations can use a variety of risk management techniques to avoid surprises and mitigate total cost of risk.



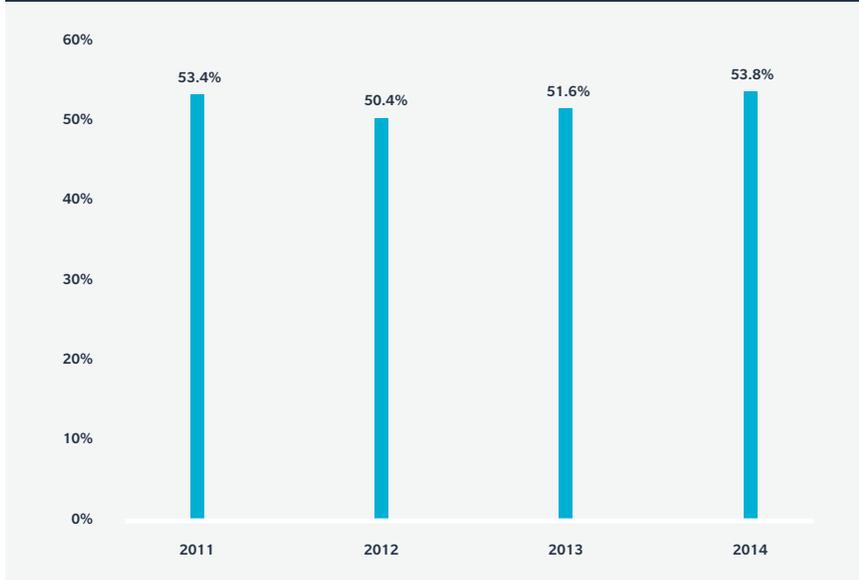
The ever increasing size of jury verdicts and aggregate litigation over the past several years demonstrates how important it is for businesses to purchase sufficient limits of liability to manage their casualty risk. Casualty insurance is intended to provide financial protection in the event of third-party liabilities but in constructing casualty insurance towers, insureds often make decisions to achieve short-term cost savings objectives. These choices can have significant unintended consequences, leaving companies vulnerable to the enormous costs of defense and indemnity associated with tort liability. Insureds should not lose sight of several important aspects of their casualty programs that can radically affect their insurance coverage in the event of a significant loss.

GROWING LIABILITY COSTS

In just the last five years, the average size of the top ten jury verdicts as reported by the *National Law Journal* has increased almost threefold, with the top one hundred verdicts now averaging \$100 million. The increase in the size of verdicts is not limited to “exotic” claims as even more commonplace auto accident cases are seeing eight- and nine-figure settlements and verdicts.

Beyond these large individual verdicts, aggregate litigation — including class actions and multi-district litigation — is imposing an even higher financial cost on businesses. In 2014, 54% of companies engaged in class-action litigation, according to a survey of general counsel, chief legal officers, and direct reports to general counsel conducted by law firm Carlton Fields Jordan Burt (see Figure 1). More than one in three companies also reported managing multiple class actions on a regular basis. And these suits are more than mere nuisances: High-risk or “bet-the-company” class actions have risen to 16.4% of all matters, up from 4.5% in 2013.

FIGURE 1 Companies with Class-Action Matters
Source: 2015 Carlton Fields Jordan Burt Class Action Survey



HIGHER RETENTIONS

One way that insureds may restructure their casualty insurance program is to take higher retentions, which insurers may insist on for some insureds and classes of business. While assuming higher retentions is a legitimate risk management technique, it can have unforeseen consequences in the event of certain types of claims.

An insured may assume the worst-case scenario is having to pay a single retention, but depending on the scope of the retention, the nature of the claim, and the applicable law, an insured could end up bearing many retentions in the event that a claim triggers multiple years, or multiple claims arising out of the same defect are deemed to arise out of multiple occurrences. For example:

- If an occurrence triggers bodily injury or property damage in several consecutive policy years, an insured may have to bear a separate self-insured retention

for each policy year in which bodily injury or property damage occurred.

- If a defective product leads to bodily injury to a large number of individuals, an insured may have to satisfy a separate self-insured retention for each allegedly injured person, depending on the applicable law, if the retention applies to each and every occurrence without any aggregate. In some jurisdictions — most notably, New York and California — each allegedly injured plaintiff may be deemed to be a separate occurrence, thus resulting in the insured having to bear a separate retention for each potential plaintiff.
- If the retention is unaggregated, the insured's decision to assume a larger retention could effectively leave the insured without coverage if the retention is larger than each plaintiff's alleged damages.

If improperly executed, certain risk management strategies can negatively affect an insured's financial exposure to the significant costs of litigation, aggregate litigation, and rising compensatory and punitive damages verdicts.

"BATCH" CLAUSES

One method of mitigating the effect of high per occurrence unaggregated retentions is to include a "batch clause" in an insured's policies, but this too can have unanticipated, potentially negative consequences. The purpose behind batch clauses is to combine claims that otherwise would each be deemed separate occurrences into a single occurrence. But it could be argued that many batch clauses may actually increase the likelihood that each claim will be deemed a separate occurrence, or may lead to gaps in coverage if the batch clause wordings are not consistent throughout the tower.

Many batch clauses are limited in scope, and only group certain claims — for example, those arising out of the same lot or batch of product produced at the same location, date, and time, and bearing the same product identification number. As such, these clauses may not have the effect of batching claims into a single occurrence depending on

the nature of the insured's business. Even worse, an insurer may argue that the batch clause has the effect of narrowing the definition of occurrence in an insured's policy, so as to increase the possibility that claims arising out of the same defect may be deemed separate occurrences, each subject to a separate self-insured retention.

Putting aside their potentially narrow scope, the inconsistency in batch clauses in a tower may also lead to gaps in coverage. For example, if policies lower in the tower group claims into a single policy year, but excess policies higher in the tower do not, the higher excess policies may not recognize underlying erosion.

In short, batch clauses may be an effective technique for addressing high, per occurrence retentions. But if they are not drafted properly, or are not consistent throughout the tower, they can be ineffective — and, an insurer may argue, have the unanticipated effect of restricting the policy definition of an occurrence.

QUOTA SHARE LAYERS

In an effort to lower premium costs, especially for difficult-to-place classes of business, many businesses have several insurers quota share a single layer of coverage. For example, an insured might place coverage for a layer providing limits of \$75 million excess of \$50 million in underlying coverage with three different, unrelated insurers. Here, each insurer provides \$25 million in limits as part of the overall layer of \$75 million in coverage.

A quota share arrangement can often provide capacity and limits at a lower premium than an insured could

otherwise obtain. Nonetheless, it can sometimes unexpectedly result in difficulties and inconsistencies in defending and resolving claims if the quota share insurers in a particular layer have differing views. For example, the insurers may disagree on whether and to what extent a claim is covered and how it can best be defended and resolved.

Generally, the insurers in a quota share layer each retain the right to make a coverage determination, independently assess the value of a claim, and determine how it should be defended. The quota share insurers do not agree to let one of the insurers or a third-party administrator or other outside party make binding coverage, settlement, or defense determinations. At a minimum, this arrangement can increase the work that the insured needs to do in advising insurers and in obtaining coverage determinations as well as in consenting to the way a claim within the quota share layer is being defended and/or settled. While the carriers in a quota share layer often are in agreement with respect to a claim, the potential for divergent opinions on coverage, settlement, and defense can be an unanticipated consequence.

PUNITIVE DAMAGES

One issue that often does not get the attention it deserves is coverage for punitive damages, which can affect an insured's ability to settle problematic claims, regardless of whether the claim results in a punitive damages verdict. Even if an award of punitive damages is deemed to be covered under a policy, the applicable law of a state may prohibit insurance from covering any punitive damages award. Insureds can address the potential

that public policy will preclude coverage in two ways:

- A most favored jurisdiction (MFJ) or most favored venue (MFV) endorsement, which attempts to increase the likelihood that the insurability of punitive damages is covered by the law of a state that permits punitive damages to be insured.
- An offshore punitive damage wrap policy, which is issued by an offshore carrier not subject to US jurisdiction that specifically insures punitive damages.

Punitive damage wrap policies have paid out on punitive damage awards; in contrast, MFJ endorsements are relatively untested and have been disapproved by New York's Department of Financial Services. For these reasons, punitive damage wrap policies are considered superior to MFJ endorsements.

Nonetheless, a significant percentage of insureds do not have either an MFJ endorsement or a punitive damage wrap policy, presumably because they do not contemplate the risk that a punitive damages verdict could be entered against them. Even if a punitive damages verdict is not likely, insureds often fail to appreciate the unintended consequence on settlements of the absence of coverage for punitive damages. Specifically, if a plaintiff justifies a high settlement demand based on the potential for punitive damages, an insurer may argue that any settlement should include a contribution by an insured to the extent punitive damages are uninsurable if the insured does not have either an MFJ endorsement or a punitive damages wrap policy.

While Marsh disagrees with insurers' argument that an insured should contribute to such a settlement, we have seen insurers take this position. If an insured had procured an MFJ endorsement and/or a punitive damage wrap, it would reduce the likelihood that an insurer could make this argument. Therefore, in determining whether to procure an MFJ endorsement or punitive wrap policy, insureds should not only consider the financial effect on a punitive damages award, but also the unintended consequence on settlements that the lack of an MFJ endorsement or punitive damage wrap policy could have.

CONTRACTUAL ALLOCATION OF RISK

A common risk management technique is the contractual allocation of risk, including indemnification and additional insured provisions in contracts with third parties. But adding another party as an additional insured may provide the additional insured

with access to coverage for claims for which it was not intended to get coverage, or to limits in excess of what the insured intended to provide to the additional insured.

Provisions in contracts with vendors, contractors and subcontractors, and other third parties requiring an insured to add another party as an additional insured are usually not unlimited. Often, the additional insured is only entitled to coverage for claims arising out of the insured's negligence, and the additional insured's coverage is limited to less than the full limits of liability of the insured's tower. Unfortunately, insureds often fail to ensure that these limitations on the additional insured's rights are spelled out in the contract and in the insurance policy or any endorsement thereto.

The insured's failure to limit the additional insured's rights in both the contract and the policy can give the additional insured the right to coverage for its own negligence, or to allow it access to the full limits of the insured's casualty insurance

tower. Courts have frequently refused to impose any limitation on an additional insured's rights to coverage where such limitations were not clearly spelled out in the contract and the insured's policies. It is therefore important that the contractual allocation of risk be properly documented both in contracts and insurance policies so as to avoid the unexpected consequence of additional insureds getting coverage for claims and limits to which they were not supposed to be entitled.

CONCLUSION

If properly executed, the risk management techniques discussed above are legitimate methods of mitigating an insured's total cost of risk. But if used in inappropriate situations or improperly executed, they can negatively affect an insured's financial exposure to the significant costs of litigation, aggregate litigation, and rising compensatory and punitive damages verdicts.

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