COMMITTEE ON INSURANCE COVERAGE LITIGATION

Coverage

Section of Litigation
American Bar Association

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Editor in Chief: Erik A. Christiansen

Published by LexisNexis
Volume 21, Number 1, January/February 2011

Articles

Unresolved Issues in Allocation of Loss to Insurance

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The methodology applicable to the allocation of long-tailed losses to insurance coverage has been heavily litigated, and the resultant rules vary significantly across jurisdictions. Despite this substantial variation, a common two-step structure has emerged: First, losses are assigned to policy periods; and, second, the losses assigned to a particular policy period are allocated to the applicable policies within each period.

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Unresolved Issues in Allocation of Loss to Insurance

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The first step within this framework, the allocation of loss to policy periods, is essentially a function of straightforward implementation of the "trigger-of-coverage" theory embraced by the court in which the particular coverage dispute is pending. As discussed in more detail below, practitioners generally agree on the proper implementation of this step.

> ***Achieving seamless coverage for long-tailed losses is frequently at odds with strict construction and enforcement of the applicable policy language***

In contrast, many outstanding issues remain regarding the second step, and practitioners approach the resolution of these uncertainties in various ways. The fundamental reason for alternative resolutions of the second step is that achieving seamless coverage for long-tailed losses is frequently at odds with strict construction and enforcement of the applicable policy language. In general, insurers typically urge adherence to the policy language, which can produce gaps in coverage. Conversely, policyholders typically rely on their intent to procure, and benefit from, seamless coverage—an objective possibly at odds with a straightforward reading of the relevant policy provisions.

Below we explore this tension through the examination of a series of examples in which achieving the goal of seamless coverage and strict enforcement of applicable policy language apparently conflicts. To set the stage for this discussion, we first more fully describe the fundamental two-step process of allocation and the manner in which practitioners and courts have resolved the first step.

Allocations Adhere to a Two-Step Framework

The allocation of long-tailed losses to insurance coverage can be viewed as a two-step process. The first step allocates liabilities—for which the policyholder has a legal obligation to one or more third-party claimants—to periods of time in which this policyholder maintained liability insurance (Step 1). The second step allocates the losses assigned to each policy period to the individual insurance policies that were in effect during that policy period (Step 2). To demonstrate this process, we begin with a straightforward example similar to those used by the courts to illustrate their rulings.

Once the basic principles have been illustrated, we modify the initial hypothetical example to demonstrate how practitioners have applied these concepts to concrete, real-world coverage determinations.

Mechanics of the Two-Step Process as Implemented by the Courts

Table 1 reflects key characteristics of an illustrative policy registry of the sort typically used to explain judicial rulings regarding allocation. The policies referred to are single-year policies with concurrent coverage periods.

Table 1: Example Policy Registry

Period	Policy	Excess	Limits
Year 1	Primary	$0	$1,000,000
Year 2	Primary	$0	$1,000,000
	Umbrella	$1,000,000	$2,000,000
Year 3	Primary	$0	$1,000,000
	Umbrella	$1,000,000	$2,000,000
	Excess	$3,000,000	$3,000,000

Figure 1 depicts an insurance chart corresponding to the policies described in Table 1. As illustrated in the graphic, each year constitutes a distinct policy period with a well-defined tower of coverage. For example, a single primary policy supplies the entirety of the insured's liability coverage for the first policy year, while the third policy year has three policies: the primary, umbrella, and excess policies. Importantly, no policy overlaps multiple policy years. Below we discuss the allocation of a $6 million loss triggering three years of coverage to each year of this policy chart.

Pro Rata Time-on-Risk Allocation

Under a pro rata time-on-risk allocation, each year within the time period implicated by the claims giving rise to the insured's liabilities for which it seeks coverage is assigned losses in proportion to

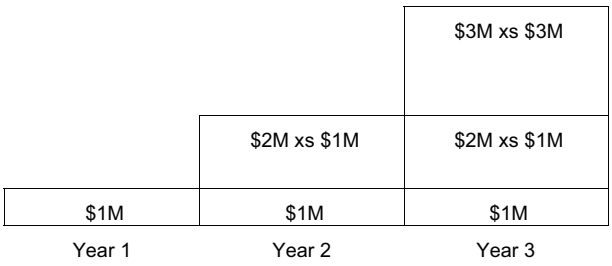

Figure 1: A Three-Period Allocation Example

the duration of the period. Because each of the three annual policy periods contemplated by Table 1 and Figure 1 is of equal duration, it is assumed that the relevant trigger-of-coverage period is three years, and each of the three policy periods receives one third of the loss. One third of the insured's $6 million liability is $2 million; thus a pro rata time-on-risk allocation assigns each policy year $2 million of loss. The first row of Table 2 reflects this outcome for Step 1 under a pro rata time-on-risk allocation.

Table 2: Pro Rata Time-on-Risk Allocation of $6 Million

Step	Year 1	Year 2	Year 3
Step 1	$2,000,000	$2,000,000	$2,000,000
Step 2			
Primary	$1,000,000	$1,000,000	$1,000,000
Umbrella		$1,000,000	$1,000,000
Excess			$0
Policyholder	$1,000,000	$0	$0

Once Step 1 is complete, Step 2 allocates the amounts assigned to each policy period to the applicable policies within that period. For the first policy year, the policyholder purchased only $1 million of primary insurance. Thus the primary policy pays $1 million, and the remaining $1 million is uninsured and must be absorbed by the policyholder. For each of the second and third policy years, the primary policy pays the first $1 million of loss assigned to the policy year, and the umbrella policy pays the second $1 million (the excess policy and the policyholder pay nothing). The lower portion of Table 2 reflects this outcome for Step 2.

Carter-Wallace Allocation

Under a *Carter-Wallace* allocation, each year within the trigger-of-coverage period is assigned losses in proportion to the duration of the period, weighted by limits[1]. As in the case of the pro rata time-on-risk allocation illustrated above, each of the three annual policy periods is of equal duration. Therefore the duration component is the same for all three policy periods. However, each policy period has distinct total limits associated with it: $1 million in limits for the first policy year; $3 million for the second policy year; and $6 million for the third policy year. Thus the first policy year has $1 million of the $10 million in total available limits, or 10 percent of the total limits. Because it is of equal duration to the other policy periods and has 10 percent of the total limits, the *Carter-Wallace* allocation assigns the first policy year 10 percent of the loss or $600,000 (10 percent of $6 million). Similarly, the second policy year has 30 percent of the limits ($3 million out of $10 million), so the *Carter-Wallace* allocation assigns that period 30 percent of loss or $1.8 million (30 percent of $6 million). Finally, the third policy year has 60 percent of the limits ($6 million out of $10 million), so the *Carter-Wallace* allocation assigns that period 60 percent of loss or $3.6 million (30 percent of $6 million). The first row of Table 3 reflects this outcome for Step 1 under a *Carter-Wallace* allocation:

Table 3: *Carter-Wallace* Allocation of $6 Million

Step	Year 1	Year 2	Year 3
Step 1	$600,000	$1,800,000	$3,600,000
Step 2			
Primary	$600,000	$1,000,000	$1,000,000
Umbrella		$800,000	$2,000,000
Excess			$600,000
Policyholder	$0	$0	$0

An alternative way to view the mathematics underlying Step 1 of a *Carter-Wallace* allocation is from the perspective of the proportions of coverage exposure. The policyholder purchased three times as much insurance for the second policy year as it did in the first policy year ($3 million versus $1 million). Therefore, the second policy year involves three times as much available coverage for liabilities potentially allocated to that year as the first policy year ($1.8 million versus $600,000). Similarly, the policyholder purchased twice as much insurance for the third policy year as it did in the second policy year ($6 million versus $3 million). Therefore, the third policy year bears twice as much coverage exposure as the second policy year ($3.6 million versus $1.8 million).

Step 2 of the *Carter-Wallace* methodology allocates the amounts assigned to each of the three policy periods to the applicable policies within these periods. For the first policy year, the primary policy pays the entire $600,000. For the second policy year, the primary policy pays the first $1 million of loss assigned to that policy year, thus exhausting its limits, and the umbrella policy pays the remaining $800,000. For the third policy year, the primary policy pays the first $1 million of assigned loss, the umbrella policy pays the next $2 million of loss, thereby exhausting the first two layers of coverage, and the excess policy pays the remaining $600,000. In contrast to the pro rata time-on-risk allocation, none of the $6 million in losses are uninsured and thus borne by the policyholder. The lower portion of Table 3 reflects this outcome for Step 2.

"All Sums" Allocation

Under the ''all sums'' (or ''joint-and-several'') approach to allocation, the policyholder is permitted to select the policy period to be assigned the loss from among the years triggered by the particular underlying liability. In the current example, the policyholder likely would choose the third policy year, as it purchased sufficient liability insurance in that year to cover the entire $6 million loss. Within the third policy year, the primary policy would pay $1 million, the umbrella policy would pay $2 million, and the excess policy would pay the remaining $3 million. Table 4 depicts this outcome.

Table 4: "All Sums" Allocation Without Equitable Contribution

Step	Year 1	Year 2	Year 3
Step 1	$0	$0	$6,000,000
Step 2			
Primary	$0	$0	$1,000,000
Umbrella		$0	$2,000,000
Excess			$3,000,000
Policyholder	$0	$0	$0

If none of the third-year insurers choose to seek equitable contribution from the insurers who issued policies in the other triggered years, then the allocation is finished. However, if the impacted insurers seek equitable contribution, then the first and second policy years would also likely be assigned part of the loss based upon a reallocation process. Under pro rata time-on-risk equitable contribution, each of the three policy years would be assigned $1 million of the first $3 million in loss. At that point, the first policy year is exhausted and is assigned no additional losses. Thus, the second and third policy years split the remaining $3 million in losses—$1.5 million to each year. The first row of Table 5 displays the ultimate amounts of $1 million to the first policy year and $2.5 million to each of the second and third policy years.

Table 5: "All Sums" Allocation when All Policies Seek Equitable Contribution

Step	Year 1	Year 2	Year 3
Step 1	$1,000,000	$2,500,000	$2,500,000
Step 2			
Primary	$1,000,000	$1,000,000	$1,000,000
Umbrella		$1,500,000	$1,500,000
Excess			$0
Policyholder	$0	$0	$0

The lower portion of Table 5 illustrates that although the excess policy was obligated for its full limits of $3 million of loss absent equitable contribution, it pays nothing after reallocation. In essence, when all impacted insurers seek equitable contribution, the allocation reduces to a modified pro rata time-on-risk allocation (i.e., the same as the initial example discussed above, except without any allocation to the insured).

Although impacted insurers have a right to equitable contribution under the law of most jurisdictions, they do not always seek it. As a result, the final allocation under an ''all sums'' approach may be affected both by the year the policyholder chooses to ''spike'' and the decisions of the ''spiked'' insurers. For example, suppose the policyholder, as before, chooses the third policy year but only the excess insurer (not the umbrella insurer) seeks equitable contribution. In this situation, the $3 million originally assigned to the excess policy would be reassigned ($1 million to the first policy year and $2 million to the second policy year), as depicted in Table 6:

Table 6: "All Sums" Allocation when the Third-Year Excess Policy Seeks Equitable Contribution

Step	Year 1	Year 2	Year 3
Step 1	$1,000,000	$2,000,000	$3,000,000
Step 2			
Primary	$1,000,000	$1,000,000	$1,000,000
Umbrella		$1,000,000	$2,000,000
Excess			$0
Policyholder	$0	$0	$0

Generalizing the Basic Mechanics to Concrete, Real-World Coverage Determinations

Relatively minor modifications to the policy chart in the previous examples are sufficient to demonstrate how quickly conflicts may arise between the (potentially) competing objectives of maintaining seamless coverage and strict interpretation of the policy provisions. For example, Figure 2 below depicts a policy chart that is identical to the previous example in all aspects except with regard to the alignment of the policy periods. In particular, the start date of each layer of coverage is staggered by six months relative to the immediately underlying layer of coverage.
Although each policy in the chart maintains a well-defined, one-year policy period, the nonconcurrency of the policy periods as between layers of coverage is immediately apparent, and policy periods for the chart

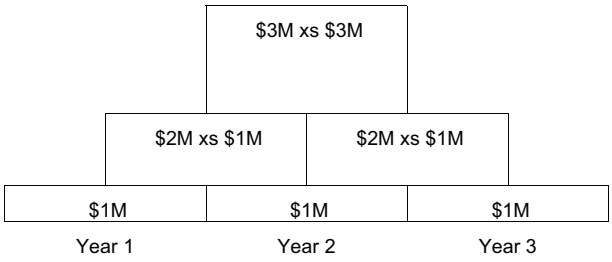

Figure 2: An Alternative Three-Period Example

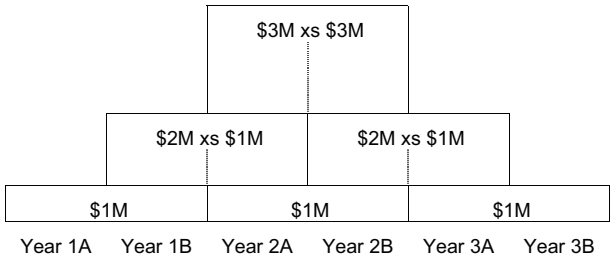

Figure 3: The Alternative Three-Period Example has Six Time Periods

itself are no longer well defined. Thus, if the entire policy periods of each of the three primary policies are triggered and adopted as the policy periods for the chart itself, then the policy periods of each of the umbrella policies overlap with two policy periods for the chart. Whenever a policy chart lacks temporal concurrency among the policies in each layer of coverage, practitioners are forced to adapt the illustrative examples established by the courts, as discussed above, to new and more complex circumstances.

Most practitioners have adopted a common framework involving subdivision of the triggered coverage block into incremental time periods

With regard to implementing Step 1 in the allocation process when nonconcurrent policies are involved, most practitioners have adopted a common framework involving subdivision of the triggered coverage block into incremental time periods (sometimes referred to as ''towers'') such that the otherwise nonconcurrent but overlapping coverage layers are consistent in at least some of the resulting periods. Figure 3 below illustrates this methodology, dividing the three-year coverage period into six-month increments, each depicted by a separate tower of insurance coverage. The tower associated with Year 1A contains only the first-year primary policy; the tower associated with Year 1B contains the first-year primary policy and the first umbrella policy; the tower associated with Year 2A contains the second-year primary policy, the first umbrella policy, and the excess policy; and so on.

Now consider the pro rata time-on-risk allocation of a $6 million loss to this alternative conception of the insured's coverage. As before, each of the three years receives one-third of the $6 million loss, or $2 million per year. We now further divide this allocated loss as $1 million to each half of each of the years. For example, Year 1A receives $1 million, and Year 1B receives $1 million for a total of $2 million for Year 1. The first row of Table 7 reflects this outcome for Step 1 under a pro rata time-on-risk allocation. Step 2 then allocates the amounts assigned to each time period to the applicable policies within that period. The lower portion of Table 7 reflects the results of this step.

Of note, the final allocation outcome for this scenario is effectively identical to the allocation reflected by Figure 1 and Table 1 above: Each of the three primary policies pays $1 million, each of the two umbrella policies pays $1 million, and the policyholder pays the remaining $1 million with no penetration of the single excess policy layer. Thus, overlapping policy periods do not affect this pro rata time-on-risk allocation. This result is not specific to the current example. In general, overlapping policy periods do not affect pro rata time-on-risk allocations. (However, as demonstrated below, policies of different durations within the same policy chart will affect the pro rata time-on-risk allocation.)

Table 7: Pro Rata Time-on-Risk Allocation of $6 Million

Step	Year 1A	Year 1B	Year 2A	Year 2B	Year 3A	Year 3B
Step 1	$1,000,000	$1,000,000	$1,000,000	$1,000,000	$1,000,000	$1,000,000
Step 2						
Primary	$1,000,000		$1,000,000		$1,000,000	
Umbrella		$1,000,000		$1,000,000		
Excess			$0			
Policyholder	$500,000	$0	$0	$0	$0	$500,000

In contrast to pro rata time-on-risk allocations, overlapping policy periods do affect *Carter-Wallace* allocations. Consider the *Carter-Wallace* allocation of a $2 million loss to the altered (Figure 3) policy chart. Because each six-month time period is of equal duration, *Carter-Wallace* allocates the loss in proportion to the coverage limits available in each triggered time period. Year 1A has 5 percent of the limits ($1 million × ½ year = $500,000 out of $10 million in overall coverage), so the *Carter-Wallace* methodology assigns it 5 percent of loss, or $100,000 (5 percent of $2 million). Utilizing the same premises, Year 1B has 15 percent of the limits ($3 million × ½ year = $1.5 million out of $10 million), so *Carter-Wallace* assigns it 15 percent of loss, or $300,000 (15 percent of $2 million). The same analysis assigns 30 percent of the $2 million loss, or $600,000, to both Year 2A and Year 2B ($6 million × ½ year = $3 million out of $10 million), 15 percent of the $2 million loss, or $300,000 ($3 million × ½ year = $1.5 million out of $10 million) to Year 3A and the remaining 5 percent of the $2 million loss, or $100,000, to Year 3B ($1 million × ½ year = $500,000 out of $10 million). The first row of Table 8 reflects this outcome for Step 1 under a *Carter-Wallace* allocation. Step 2 then allocates the amounts assigned to each time period to the applicable policies within that period. The lower portion of Table 8 reflects the Step 2 results. The first-year primary policy pays the $400,000 assigned to Year 1. Similarly, the third-year primary policy pays the $400,000 assigned to Year 3. Turning to Year 2, the second-year primary policy pays the first $1,000,000. That leaves $200,000 of loss assigned to Year 2 for which no coverage exists. Despite the insured's purchase of what might appear to be seamless coverage, it turns out that neither of the insured's umbrella policies provide coverage for this remaining $200,000. The applicable primary policy is exhausted, but neither of the umbrella policies is attached, notwithstanding the existence of loss beyond primary limits.

To understand why the umbrella polices do not respond, we look at the loss assigned to their respective policy periods. The total loss assigned to the policy period of the first umbrella policy (Year 1B and Year 2A) is $900,000. The first umbrella policy was written to provide coverage in excess of $1 million. Therefore, under a strict construction of the coverage provisions set forth in the umbrella policy, insufficient loss exists within its effective policy period to reach its attachment point. Likewise, the total loss assigned to the policy period of the second umbrella policy (Year 2B and Year 3A) is $900,000, which is less than its $1 million attachment point.

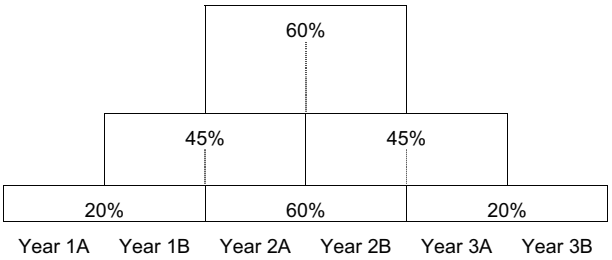

Figure 4: Nonconcurrent, Overlapping Policy Periods Create Differing Erosion Rates that Lead to Gaps in Coverage

Figure 4 further illustrates why this gap in coverage exists. The percentage displayed in the space representing each policy is the percentage of the insured's $2 million loss that *Carter-Wallace* assigns to the time period during which each such policy was in effect. As we observed above, the time interval representing the second-year primary policy is assigned 60 percent of the loss. However, the time periods representing each of the umbrella policies are assigned 45 percent of the loss. Therefore, every $100 of loss erodes $60 of the primary policy, yet only contributes $45 towards satisfying the attachment point of either of the umbrella policies. Because the limits of the second-year primary policy erode faster than the attachment points of the nonconcurrent umbrella policies are satisfied, the gap in coverage results. The presence of gaps in coverage generalizes to almost all long-tailed coverage block scenarios. In particular, gaps in coverage will emerge whenever the percentage of loss assigned to particular time periods changes as one moves forward in time (reading from left to right on the policy chart). Because policyholders—at least large, sophisticated

Table 8: *Carter-Wallace* Allocation of $2 Million

Step	Year 1A	Year 1B	Year 2A	Year 2B	Year 3A	Year 3B
Step 1	$100,000	$300,000	$600,000	$600,000	$300,000	$100,000
Step 2						
Primary	$400,000		$1,000,000		$400,000	
Umbrella	$0			$0		
Excess	$0					
Policyholder	$0	$0	$100,000	$100,000	$0	$0

policyholders—tended to buy increasing amounts of liability insurance as time moved forward through the decades from the 1950s through the 1980s, where many forms of long-tailed liability exposures emerged, the *Carter-Wallace* percentage of loss tends to increase as one moves from earlier to later dates within a triggered coverage block.

Many outstanding issues exist with regard to allocating the loss assigned to a time period to the individual policies in effect during that period

The above illustration is just one example of how nonconcurrent policies and overlapping policy periods complicate the allocation process and raise questions that may not have been directly addressed by the courts. In the next section, we more fully explore the potential impact and implications of these complicating factors as they relate to the efforts of practitioners and courts to resolve complex allocation problems.

Unresolved Issues in Step Two

In contrast to Step 1, many outstanding issues exist with regard to allocating the loss assigned to a time period to the individual policies in effect during that period. Most often the guidance pertaining to Step 2 allocation within time periods advises allocating vertically within the period, with due regard for the contract language of the implicated polices. This guidance is sufficient for purposes of the illustrative hypotheticals crafted by the courts but may be insufficient when employed in the concrete context of a real-world coverage assessment.

To illustrate, return to the third policy year in Table 1 that is reproduced in Figure 5. This year has a $1 million primary policy, a $2 million umbrella policy, and a $3 million excess policy. Following the guidance of the courts, the primary policy pays all covered losses up to $1 million; the umbrella policy pays up to $2 million in covered losses in excess of $1 million; and the excess policy pays up to $3 million in covered losses in excess of the $3 million in underlying coverage.
Figure 5 is straightforward and uncomplicated in that it depicts only single-year policies with concurrent policy periods. When all of the policies are of the same duration, cover the same losses, and have concurrent policy periods, the policyholder's expectation of seamless coverage aligns with the policy language, and the operation of the policies in accordance with their coverage provisions are in harmony. In the sections below we will explore situations in which deviations in the coverage profile from this paradigm create ambiguities, and the policyholder's expectation of seamless coverage and the terms and conditions of coverage contemplated by the policy language diverge.

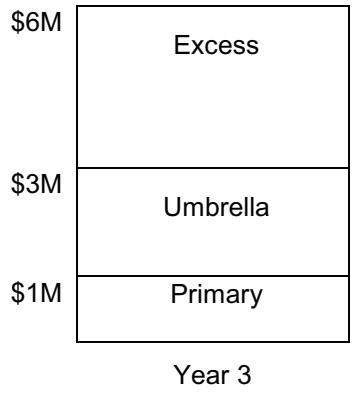

Figure 5: Illustrative Single Policy Year

Stub Policies

Our first example is relatively straightforward. We replace the single, one-year umbrella policy in Figure 5 with two six-month policies (''stubs''), each with a $2 million limit. The primary and excess policies remain unchanged.

The left-hand side of Figure 6 depicts this policy chart from the perspective of the policyholder. From that perspective, a single annual policy that provided $2 million of coverage has been replaced with two six-month stubs, each of which provides $2 million of cover for a total of $4 million of cover. Thus, the policyholder may believe it possesses more insurance than if it had purchased a single annual $2 million umbrella policy. Suppose a large, continuous loss results in the assignment of $5 million to this time period, distributed evenly as $2.5 million into each six-month interval. To achieve seamless coverage, the policyholder would likely take the position that the primary policy pays $1 million and each of the stub policies pays $2 million.

The coverage provisions of the stubs, however, may conflict with the policyholder's desire for seamless coverage. Each of the stub policies was written to provide coverage in excess of $1 million of loss within its policy period. Based upon an even apportionment of the insured's $5 million loss between the first six months of the year and the second six months of the year, even though the primary policy's limits of $1 million are exhausted, only $500,000 of that amount comes under umbrella Stub 1 and umbrella Stub 2, respectively, leaving a gap of $500,000 before either of the stub policies is reached. Even in the absence of a complete exhaustion requirement,

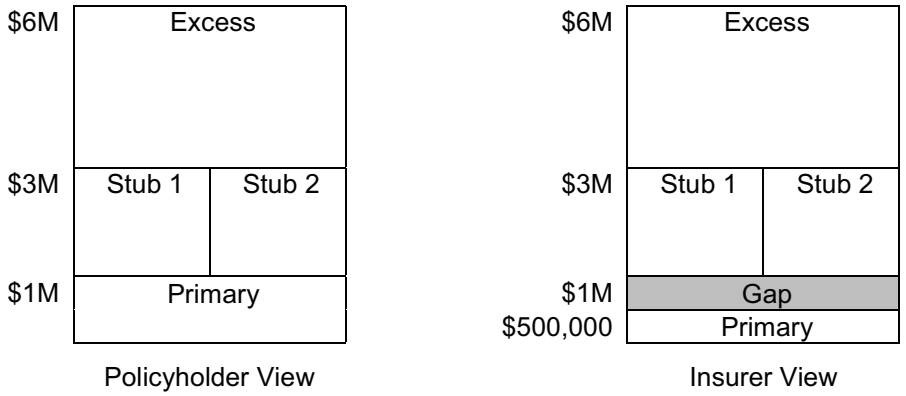

Figure 6: Policyholder and Insurer Views of Stub Policies

each umbrella policy would only pay $1.5 million, resulting in total coverage of $4 million, rather than the $5 million sought by the insured.

The right-hand side of Figure 6 depicts the coverage chart from the perspective of the insurers, inclusive of this gap in coverage. Each of the six-month stub policies is written in excess of $1 million. Because these two stub policies do not overlap temporally, each requires a distinct $1 million of underlying loss in its policy period to be reached. Thus, $2 million of underlying loss is needed to attach both stub policies. However, the primary policy has only a $1 million limit. The discrepancy between the $1 million limit of the primary policy and the $2 million of underlying loss required to attach both of the two stub policies results in a $1 million gap in coverage.

This situation is not uncommon. Stub policies appear regularly in the real-world coverage profiles of large, sophisticated insureds. In such a circumstance, some practitioners and courts might seek to vindicate the objective of seamless coverage by triggering the stub policies notwithstanding the failure to satisfy the underlying loss provisions of the policies. Under this approach, the attachment point of each stub is effectively reduced by half, from $1 million to $500,000, so that seamless coverage is maintained. This outcome undoubtedly impairs the interests of the insurers that issued the stub policies by accelerating and potentially increasing the amount of loss allocated to those policies.

Other practitioners and courts might strictly enforce the language and intent of the stub policies, leaving a gap in coverage. In the above example, the gap would be $1 million. This outcome unambiguously prejudices the policyholder to the extent it had a reasonable expectation of seamless coverage.

A third possible approach exists. Typically the premium paid for each of the six-month stubs is about equal to half the premium of a single, one-year policy with essentially identical terms. Given that the aggregate premium is about the same, this third variation effectively treats the two stubs as if they were a single, one-year policy. Thus, the underlying loss amount for each stub is pro-rated to $500,000 (half a year receives half the underlying loss), and the umbrella aggregate limit is pro-rated to $1 million (again, half a year receives half the limit). Under this treatment, the policyholder has seamless coverage, the terms of the primary and excess policies are observed, and the stub policies receive the benefit of a reduction in their limits to counterbalance the cost of a lowering of their attachment points.

Multiyear Policies

Multiyear policies present complexities analogous to those presented by stub policies. Figure 7 depicts a two-year policy chart we will use to illustrate the impact of multiyear policies. That chart contains two one-year $1 million primary policies, a single two-year $2 million umbrella policy, and two one-year $3 million excess policies. We consider the situation in which the $2 million limit of the umbrella policy applies exactly once for the entire policy period (i.e., the two-year policy does not contain any language suggesting that it may be treated as two one-year policies with a full limit for each period). In this case, the policyholder's expectation of seamless coverage conflicts with the policy language. To illustrate this conflict, suppose a large, continuous loss results in the assignment of $6 million of liabilities to this two-year period, distributed evenly as $3 million into each year. To maintain seamless coverage, the policyholder needs each of the primary policies to pay $1 million, the umbrella policy to pay $2 million, and each of the excess policies to pay $1 million. The left-hand side of Figure 7 reflects this putative interpretation of the policy chart.

The coverage provisions of the excess policies do not support the seamless coverage allocation desired by the policyholder. Each of the one-year excess

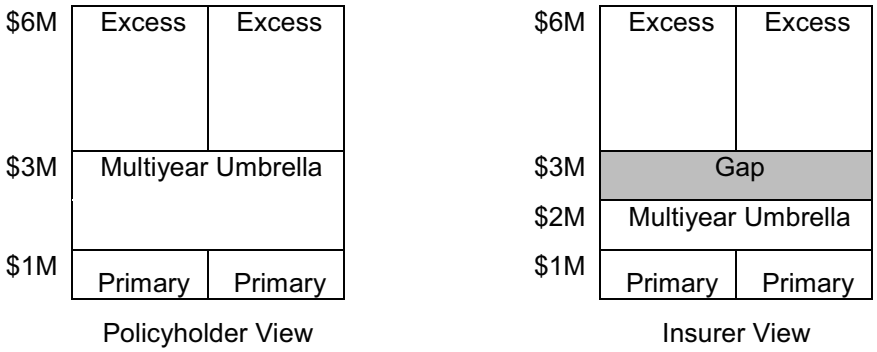

Figure 7: Policyholder and Insurer Views of Multiyear Policies

policies is written to provide coverage in excess of $3 million. Enforcing the policy language would allocate $0 to each excess policy under the circumstances of the hypothetical, because the loss in each excess policy's policy period does not rise to the level of its attachment point. In this situation, the policyholder is reimbursed for only $4 million of its $6 million loss—$1 million from each of the one-year primary policies and $2 million from the two-year umbrella policy.

The right-hand side of Figure 7 depicts this coverage chart from the insurers' perspective, inclusive of the gap in coverage. Each of the excess policies is written in excess of $3 million. Because these two excess policies do not overlap temporally, each requires a distinct $3 million of underlying loss in its policy period in order to be reached. Thus, $6 million of underlying loss is needed to attach both excess policies. However, the limits of the underlying insurance total only $4 million. The discrepancy between the $4 million in underlying limits and the $6 million of underlying loss required to attach the two excess policies results in a $2 million gap in coverage.

Any policy with a single limit for more than 12 months of coverage can result in a gap in coverage.

Variants of this scenario are commonplace. In particular, any policy with a single limit for more than 12 months of coverage can result in a gap in coverage if there are nonconcurrent policies in lower and/or higher layers and its policy period attachment point is strictly enforced. In addition to multiyear policies, single-year policies that are amended to extend the term of the policy without reinstating the limits for the additional coverage period fit this fact pattern. These policies frequently have durations of 13 to 18 months, subject to a single, per-occurrence or aggregate limit for the entire period.

General Case

To illustrate the general case, we return to the *Carter-Wallace* example from Section 2. For ease of reference, Figure 8 replicates the Figure 2 policy chart—a three-year coverage block in which the policy periods for the umbrella policies overlap with those of the primary and excess policies. Table 9 through Table 11 below display the *Carter-Wallace* allocation of loss to this policy chart for three distinct levels of loss. These two illustrations highlight where the tension exists between the policyholder's expectation of $10 million of seamless coverage under *Carter-Wallace* and the insurers' expectation that their contract language will be honored. The first situation highlights how nonconcurrent policy periods can result in the policyholder reaching "blue sky" (i.e., exhausting all insurance for a specific time period) more quickly than expected. The second situation highlights how nonconcurrent policy periods can generate gaps in coverage.

The first row of data in Table 9 displays the share of loss assigned to each six-month period under the *Carter-Wallace* allocation formula. Recall that because the allocation is proportional to the amount of insurance purchased for each time period, the percentage of overall coverage within a particular period grows as the height of the policy chart increases. In particular, the policy chart increases from $1 million to $3 million between the first and second six-month periods. Thus, the percentage in

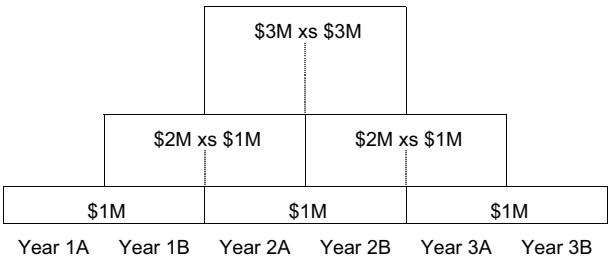

Figure 8: Three-Year Coverage Block with Overlapping Policy Periods

Table 9: The Policyholder May Reach "Blue Sky" Earlier than Expected

Step 1	Year 1A	Year 1B	Year 2A	Year 2B	Year 3A	Year 3B
Shares	5%	15%	30%	30%	15%	5%
Policyholder first runs out of insurance for select periods	$250,000	$750,000	$1,500,000	$1,500,000	$750,000	$250,000
	First and third year primary exhaust (Year 1A + Year 1B = $1 million); no insurance remains for Year 1A and Year 1B					

the second six-month period (15 percent) is assigned three times the loss of the first six-month period (5 percent). Similarly, the chart increases again from $3 million to $6 million between the second and third six-month periods. Thus, the third six-month period is assigned twice as much of the loss (30 percent) as the second six-month period (15 percent). The remaining time periods and assigned percentages of total coverage continue to mirror the height of the policy chart. Although the assignment of loss to time periods remains relatively straightforward, the allocation of loss to policies within each period is more complicated than before. The process is analogous to filling a tub with multiple faucets. In this analogy, view the first-year primary policy as an empty tub and the losses assigned to Year 1A and Year 1B, respectively, as the faucets. The first faucet, Year 1A, is filling the tub from one end (the first six months of Year 1). The second faucet, Year 1B, is filling the tub from the other end (the second six months of Year 1). Despite the fact that the second faucet is flowing at three times the rate of the first, the tub continues to hold the water from both faucets until it is full. Furthermore, once the tub is full, additional water from either faucet will cause it to overflow (i.e., be borne by the umbrella policy or the policyholder).

With this analogy in mind, we turn to the second row of Table 9, which reflects the allocation at the moment the first-year primary policy exhausts. Exhaustion occurs when the policy has been allocated $1 million. At this point, $250,000 of loss assigned to Year 1A has been allocated to the policy (through faucet one), and $750,000 of loss assigned to Year 1B has been allocated to the policy (through faucet two). Thus, the first-year primary policy covers three times the loss associated with Year 1B as associated with Year 1A, because the faucet associated with Year 1B is flowing at three times the rate.

This illustration demonstrates that the first-year primary policy will exhaust when the policyholder's aggregate losses triggering this three-year coverage period reach $5 million. Thus, for any losses in excess of $5 million, the policyholder lacks insurance for Year 1A. As a result, despite having purchased $10 million of insurance limits, the policyholder will bear any portion of the loss allocated to Year 1A if its overall liability exceeds $5 million. Similarly, the third-year primary policy exhausts when the policyholder's aggregate losses reach $5 million, leaving the policyholder to bear any additional losses assigned to Year 3B.

In addition to reaching uninsured status sooner than a policyholder may have expected, nonconcurrent policy periods can create gaps in the middle of the policy chart. Table 10 helps illustrate this situation in our current example by stopping the Step 2 allocation at two critical junctures.

First, the allocation depicted by Table 10 cuts off at the moment the second-year primary policy exhausts. At this point, $500,000 of loss has flowed into the second-year primary policy from each of Year 2A and Year 2B. Thus the second-year primary pays a total of $1 million and is exhausted.

Table 10: The Policyholder May Have Unexpected Gaps in Coverage

Step 1	Year 1A	Year 1B	Year 2A	Year 2B	Year 3A	Year 3B
Shares	5%	15%	30%	30%	15%	5%
Commencement of a potential gap in coverage	$83,333	$250,000	$500,000	$500,000	$250,000	$83,333
	Year 2 primary policy is exhausted (Year 2A + Year 2B = $1 million); the umbrella policies are not attached (Year 1B + Year 2A = $750,000 < $1 million)					
Termination of the potential gap in coverage	$111,111	$333,333	$666,666	$666,666	$333,333	$111,111
	Umbrella policies attach (Year 1B + Year 2A = $1 million); $333,333 gap (Year 2A + Year 2B = $1,333,333 and primary pays only $1 million)					

Table 11: *Carter-Wallace* Allocation of $10 Million

Step	Year 1A	Year 1B	Year 2A	Year 2B	Year 3A	Year 3B
Step 1	$500,000	$1,500,000	$3,000,000	$3,000,000	$1,500,000	$500,000
Step 2						
Primary	$1,000,000		$1,000,000		$1,000,000	
Umbrella		$2,000,000		$2,000,000		
Excess			$1,444,444			
Policyholder	$250,000	$361,111	$166,667	$166,667	$361,111	$250,000

To satisfy the policyholder's expectation of seamless coverage, the umbrella policies would need to start paying any additional losses assigned to the time period occupied by the second-year primary policy. However, the underlying loss amount for the umbrella policies is not satisfied. This disconnect occurs because the primary coverage periods underlying each of the nonconcurrent umbrella policies are assigned only $750,000 of loss (e.g., $250,000 from Year 1B and $500,000 from Year 2A combine for $750,000 of loss underlying the first umbrella policy). Therefore, it is impossible to simultaneously maintain seamless coverage and strictly honor the contract language of the umbrella policies.

This potential gap in coverage persists until the underlying loss amount of each umbrella policy has been satisfied. The third row of Table 10 stops the allocation when that occurs. The umbrella policies attach when $1 million of loss has been assigned to the primary coverage periods underneath them. Considering the first umbrella policy, this condition is met when one-third of $1 million has been assigned to Year 1B and two-thirds of $1 million has been assigned to Year 2A. Thus, between the time the second-year primary policy exhausts and the umbrella policies attach, there may be a gap in coverage. In this example, that gap would cost the policyholder one-third of $1 million.

Table 11 reflects the allocation of a full $10 million loss when the contract language of the relevant umbrella and excess policies is honored. The overlapping policy periods and resulting misalignment of underlying limits with the attachment points of higher-level policies causes the policyholder to pay a portion of the loss assigned to every time period, despite the policyholder's intent to purchase and belief that it had purchased $10 million of seamless coverage.

Although many practitioners and courts would endorse as correct (and fair) the allocation reflected by Table 11, others would endorse the alternative allocation depicted in Table 12 as correct (and fair). The approach depicted in Table 12 is often referred to as partitioning policy limits. Note that in Step 1, the assignment of loss to time periods remains the same under the partitioning limits approach. However, Step 2 differs. The key difference in Step 2 is that the latter allocation artificially treats each time period as though it contains distinct policies subject to distinct limits that are unaffected by the other time periods. Returning to the analogy of the faucets, dividers have been placed in the tubs such that each time period is a separate receptacle. For example, the $1 million first-year primary policy is two distinct tubs of $500,000. The first tub accepts water (allocated loss) only from faucet 1A, and the second tub accepts water (allocated loss) only from faucet 1B. Thus the second tub that corresponds to Year 1B can be full (exhausted), and water can flow up into the next level (attach the umbrella policy), even though the first tub that corresponds to Year 1A is not full (i.e., the primary policy has limits remaining).

Under this treatment, the first-year primary policy pays the first $500,000 of loss assigned to each of Year 1A and Year 1B. The second-year and third-year primary policies also pay the first $500,000 of loss assigned to each six-month period comprising their constructive policy periods. Similarly, the first

Table 12: *Carter-Wallace* Allocation of $10 Million (maintaining seamless coverage)

Step	Year 1A	Year 1B	Year 2A	Year 2B	Year 3A	Year 3B
Step 1	$500,000	$1,500,000	$3,000,000	$3,000,000	$1,500,000	$500,000
Step 2						
Primary	$500,000 + $500,000		$500,000 + $500,000		$500,000 + $500,000	
Umbrella		$1,000,000 +$1,000,000		$1,000,000 + $1,000,000		
Excess			$1,500,000 + $1,500,000			
Policyholder	$0	$0	$0	$0	$0	$0

Table 13: *Carter-Wallace* Allocation of $6 Million (maintaining seamless coverage)

Step	Year 1A	Year 1B	Year 2A	Year 2B	Year 3A	Year 3B
Step 1	$300,000	$900,000	$1,800,000	$1,800,000	$900,000	$300,000
Step 2						
Primary	$300,000 + $500,000		$500,000 + $500,000		$500,000 + $300,000	
Umbrella		$400,000 + $1,000,000		$1,000,000 + $400,000		
Excess			$300,000 + $300,000			
Policyholder	$0	$0	$0	$0	$0	$0

umbrella policy pays the next $1,000,000 of loss assigned to each of Year 1B and Year 2A. Thus the primary and umbrella policies cover the entire loss assigned to Year 1B. In contrast, the primary and umbrella policies cover only the first $1.5 million of loss assigned to Year 2A, causing the remaining $1.5 million assigned to Year 2B to be allocated to the excess policy. The lower half of Table 12 reflects the outcome for this step.

Reducing the loss amount back to $6 million demonstrates the conflict between this alternative allocation and strict enforcement of the contract language. Table 13 depicts this allocation. As before, each primary policy pays up to the first $500,000 of loss assigned to each six-month period comprising its policy period. Thus the first and third primary policies each pay $800,000 ($300,000 for six months and $500,000 for the other six months), while the second-year primary policy pays its full limit of $1,000,000 ($500,000 for each six-month period). Similarly, the umbrella policies pay up to the next $1,000,000 of loss assigned to each of six-month period comprising their policy periods. Thus, each umbrella policy pays $1.4 million (the remaining $400,000 for one six-month period and the next $1 million for the other six-month period). Finally, the excess policy pays up to the next $1,500,000 of loss assigned to each of six-month period comprising its policy period (Year 2A and Year 2B). Thus the excess policy pays $600,000 (the remaining $300,000 in each of Year 2A and Year 2B).

This allocation results in three policies paying losses while the policies underlying them have limits remaining. First, the excess policy pays $600,000, despite the fact that neither of the umbrella policies underlying it are exhausted (each has $600,000 of remaining limits). Second, the first umbrella policy is paying losses assigned to Year 1B, despite the fact that the corresponding primary policy for this time period is not exhausted (it has $200,000 of remaining limits). Similarly, the second umbrella policy is paying losses assigned to Year 3A, despite the fact that the corresponding primary policy for this time period is not exhausted (it has $200,000 of remaining limits).

The ability to attach an excess policy when the policies immediately underlying it have limits remaining is not unique to this example. In practice, it is a common outcome when the limits of noncurrent policies are partitioned into separate towers of coverage, each with its own limits.

Conclusion

Allocation of long-tailed losses to policy periods has been adjudicated in many jurisdictions. The adoption of a continuous trigger-of-coverage theory has been nearly universal. The application of a continuous trigger as the basis for allocating loss, under circumstances in which the insured's coverage profile includes nonconcurrent policies in different layers of coverage, may create a conflict been the policyholder's expectation of seamless coverage and the insurers' expectation that the coverage provisions stated in their policies will be enforced in accordance with their terms. To date, the courts have provided little guidance on how to resolve such conflicts. Indeed, the examples used to illustrate the allocation results reflected by most judicial opinions disregard this potentially complex problem by using policy charts with concurrent policy periods. This article offers suggestions for the possible resolution of some of the challenging, real-world allocation complexities that the cases, for the most part, simply do not address.

[1] *See generally* Carter-Wallace, Inc. v. Admiral Ins. Co., 154 N.J. 312, 712 A.2d 1116 (1988) (adopting a modified form of pro rata allocation that takes into account duration of time on the risk during the trigger-of-coverage period as well as magnitude of available policy limits to the extent the amount of coverage maintained by the insured varied within the trigger period).

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