Splitting the Bill

Software Can Help Allocate Losses Among Multiple Policies

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In a growing number of insurance coverage disputes, the issue of allocation — how to divvy up losses among multiple policies — plays a leading role. Whenever multiple insurance policies are liable for a single loss, questions will inevitably arise as to how much each policy should pay.

Unfortunately, allocation law has become more complex in recent years as the courts have devised a number of fundamentally different frameworks and have issued conflicting decisions on many allocation sub-issues (e.g., self-insured retentions (SIRs), "stacking," "exhaustion"). Adding to this complexity is the fact that many millions of dollars often hinge on allocation outcomes. As a result, insurers and policyholders alike increasingly must spend significant resources developing allocation models and determining which model works best for each particular case.

Fortunately, today's software can play a helpful role in the allocation process and facilitate settlement of coverage disputes. The new versions of interlocking database and spreadsheet programs can bring order to the allocation chaos and are nimble enough to be employed "on the fly" during the heat of settlement negotiations.

To oversimplify, allocation law can be divided into two areas: allocation frameworks (i.e., the fundamental method by which losses are divided up among applicable policies) and allocation sub-issues (e.g., deductibles, aggregate limits, "stacking," etc.).

The courts have developed three fundamentally different allocation frameworks: (1) the "all sums" approach in which each triggered policy is jointly and severally liable for — as stated in the policy — "all sums" that the policyholder becomes liable to pay (e.g., J.H. France Refractories v. Allstate Insurance Co., 626 A.2d 501 (Pa. 1993)); (2) the "time on the risk" approach in which each triggered policy pays only its pro rata share based on the time period of that policy as a share of the total time period of all triggered coverage (e.g., Domtar Inc. v. Niagara Fire Insurance Co., 563 N.W.2d 724 (Minn. 1997)); and (3) the hybrid "years and limits" approach in which each triggered policy pays its pro rata share based on a combination of the time periods and policy limits of all triggered coverage (e.g., Owens-Illinois Inc. v. Aetna Casualty & Surety Co., 650 A.2d 974 (N.J. 1994)).
Once the appropriate allocation framework is determined, there are myriad allocation subissues to account for. Do the policies have deductibles and SIRs, and if so, how large? Do the policies have aggregate limits, and if so, to which risks do they apply? Does the loss constitute one or multiple occurrences? Can multiple per-occurrence limits be "stacked" to cover one occurrence? Can excess coverage be tapped before exhausting all primary coverage? Who is responsible for insolvent insurance policies or gaps in coverage? On what dates should the proration period begin and end? Should losses be allocated back to the policyholder for periods when coverage was not available in the market?

Literally hundreds of court decisions in recent years have addressed these and other allocation issues. While some of the issues are fairly well settled (e.g., courts generally agree that only one SIR should be paid for a single occurrence), other areas remain unresolved (e.g., the ability to "stack" multiple limits) and provide fertile grounds for imaginative allocation approaches.

With all of these variables, parties in a coverage dispute will often suggest widely different allocation approaches. The key to winning an allocation dispute is to develop an allocation model that accurately represents the terms of the specific insurance policies at issue and properly apportions the losses based on the allocation law of the relevant jurisdictions(s). Today's technologies can provide invaluable assistance toward developing such an allocation model.

**Graphing the Coverage**

Before you can allocate losses, you first need to know precisely what policies exist, as well as the essential terms of those policies. In the world of allocation, a picture is worth a thousand words — particularly when it comes to sorting out and depicting dozens or even hundreds of insurance policies issued by many different insurers. A color-coded coverage chart provides a succinct overview of the available policies, and is often an essential tool in large, multi-insurer disputes. The current generation of database and AutoCAD programs — especially when linked together — are ideal for cataloging and charting the key terms of your policy portfolio.

The first step is to load the relevant policy data — policy limits, start and end dates, carrier information, aggregate limits, solvency, etc. — onto a database program (such as Microsoft Access 2000 or Lotus Approach 9.5). The program is then linked to a graphics application (such as Autodesk AutoCAD LT 2000) that can generate colorful, large-format coverage charts. Any changes in the database are automatically incorporated (through the graphics program) into the coverage chart. Thus, as you learn more about the details of the policies that form the basis for your claim — or you simply find a new policy — this new information is added to the database. Updated coverage charts then can be readily printed as needed for little additional expense.
Heavy Allocation Lifting

Once the coverage charts are in place, you can turn to spreadsheet programs, such as Quattro Pro 9.0 or Excel 2000, to handle the heavy allocation lifting. At this stage, a thorough understanding of the relevant allocation law is critical — without it, the allocation program may look impressive, but the results won't be worth the paper they are printed on. A well-crafted allocation program accurately applies the allocation law of the relevant jurisdiction(s) — choice-of-law issues abound in the allocation area — and spreads the losses over each triggered policy, taking into account all of the relevant allocation issues.

This process can be illustrated with a simple allocation example. Assume ABC Co. is faced with 100 lawsuits based on defective product (DP) claims, and that each DP claim is valued at $400,000, for a total loss of $40 million. Assume that ABC's coverage consists of three one-year policies: The first policy has limits of $10 million with an SIR of $100,000; the second policy has limits of $20 million with an SIR of $200,000; and the third policy has limits of $30 million with an SIR of $300,000. Assume further that each DP claim "triggers" all three policies (i.e., each DP claim involves ongoing injuries during all three policy periods). Finally, assume that all of the DP claims arise in New York, but that ABC's headquarters are in Pennsylvania.

Under this example, you would need to develop two fundamentally different allocation models, one based on New York law (a "time on the risk" state) and another based on Pennsylvania law (an "all sums" state). Each of the two models would, in turn, have several variations.

For example, under the New York model, one scenario would assume that one average SIR is first deducted from each DP claim, and then the claim is spread evenly over the three available policies. A second scenario would also assume a three-year spread, but would require that three SIRs — one in each year — be paid for each claim. A third allocation scenario (the most likely in many jurisdictions) would treat all DP claims as one insurance claim (one "occurrence" in insurance jargon), requiring that only one SIR be paid for the whole group of 100 claims. Here are the results for these three scenarios:

Scenario 1: If you take the $400,000 value of a single DP claim and subtract $200,000 (the average SIR among the three policies), the difference is $200,000. That number multiplied by 100 (the total number of DP claims) produces a $20 million total recovery.

Scenario 2: First, divide the $400,000 value of the single DP claim by three, producing a $133,333-per-year allocation. In year 1, that sum would be reduced by the first policy's $100,000 SIR for a remainder of $33,333. In year 2, the $133,333 allocation would be more than offset by the second policy's required $200,000 SIR. Likewise, there would be no net payment in year 3, when the third policy's $300,000 SIR would apply. The total paid over the three years would be $33,333, which would then be multiplied by 100 for a total recovery of $3.3 million.
Scenario 3: Start by treating all 100 DP claims as a single $40 million claim, and then subtract $200,000 (the average SIR), leaving $39.8 million. That sum divided by three yields $13,266,666 per year. During year 1, just $10 million would be paid (because of the first policy's $10 million policy limit). In each of the following two years, $13,266,666 would be paid. The total recovery over three years would be $36.5 million.

These results — ranging from $3.3 to $36.5 million — illustrate the profound financial consequences that often result from allocation decisions. Application of Pennsylvania's "all sums" law would yield a whole new set of allocation outcomes. With so many variables, a key challenge is to organize and prioritize the allocation results while, at the same time, retaining flexibility to allow for future "what if" allocation scenarios.

Allocation technologies help to meet this challenge. Once the basic allocation models are prepared, you can readily change the underlying assumptions and quickly learn the new allocation results. Indeed, with the new features available in today's spreadsheet applications, such as "hot cells" and linking of multiple spreadsheets, new assumptions — e.g., 200 claims instead of 100, or a proration start date of 1958 instead of 1947 — can be run through the allocation model in seconds. Given this facility, it is not uncommon today to run a dozen or more "what ifs" in order to chart out the various potential allocation outcomes for your case.

This quickness and adaptability can come in handy during client presentations or settlement negotiations. Assume that during "hot and heavy" settlement negotiations the opposing side shows a willingness to settle, but only, for example, if there is no "stacking" of limits, or assume that total future losses will amount to no more than $25 million. These new assumptions could readily be entered on a laptop, and the allocation results would be available immediately for use in the ongoing negotiations.

**Monte Carlo Simulations**

The allocation process can be further refined with Monte Carlo risk analysis. A Monte Carlo program (such as Crystal Ball Professional 2000) produces a series of probabilities for a range of possible outcomes. Thus, in contrast to "single point" allocation models that produce a specific allocation result (for example, $3.47 million allocated to insurer "A"), a Monte Carlo model would yield a set of probability-rated outcomes (for example, a 40 percent likelihood that the allocation to insurer A will be $3.47 million or higher). By linking the Monte Carlo model directly to the allocation spreadsheets, Monte Carlo results can be built into the final allocation outcomes.

Monte Carlo programs are ideal for the typical allocation situation abounding with uncertainties. Referring back to the ABC Co. example, assume that there is a 30 percent chance that New York law will apply and a 70 percent chance of Pennsylvania law. Assume further that there is a 10 percent chance that DP claims will explode and result in total liability of $100 million, while there is an 80 percent chance of just $15 million in total DP losses. Monte Carlo programs incorporate these and any other relevant variables, run thousands of simulations, and generate a probability for each specific allocation outcome. The end product is a colorful, easy-to-read chart that shows the odds for any given outcome. You may learn, for example, that while there is
a 5 percent chance that insurer A will be allocated as much as $84 million, there is an 85 percent chance that the allocation will be no more than $12 million.

Armed with this knowledge, outlier results can be identified and discounted, and the parties can then focus their settlement negotiations on the most realistic range of allocation alternatives. Of course, as with any allocation model, the Monte Carlo programs are only as reliable as the data fed into them. Garbage in, garbage out.

**Moral of the Story**

With allocation playing a greater role in the settlement of insurance coverage disputes, it's critical that you have the tools to reliably determine allocation outcomes. The current crop of software applications is well-suited for this task. Especially when linked together, the various software programs can save time and money, simplify the allocation process, and ultimately facilitate settlement by focusing the parties on the most realistic outcomes.

However, in the end, the moral of the story remains the same: The fanciest charts and the most elaborate computer models are worthless if they are not based on accurate factual data and a thorough understanding and application of the underlying coverage law.