Definition of Single Loss in Environmental Claims Under Treaty Reinsurance

In an unprecedented case law decision, New York's Court of Appeals has held that many environmental claims from a single insured at different sites do not constitute a single loss for purposes of excess of loss treaty reinsurance policies. In its October 2001 decision, the court explained that the standard reinsurance policy definitions of disaster or casualty require multiple environmental sites to have a spatial or temporal relationship to each other as well as a common origin. The court also held that the standard follow the fortunes reinsurance clause does not change the other plain language of the reinsurance contract requiring the environmental sites to be treated as separate losses.

The decision emanates from two consolidated coverage actions in New York State court commenced by Hartford, Connecticut-based Travelers Property Casualty Corp. (a successor to Aetna Casualty & Surety Co) against Lloyd's of London and other excess of loss treaty reinsurers. Travelers sought from the treaty reinsurers approximately $21.4 million from two separate settlements of approximately $213 million paid to chemical manufacturers Koppers Co., based in Pittsburgh, and Wilmington, Delaware-based E.I. DuPont de Nemours & Co. The settlements resolved coverage actions against Travelers seeking indemnity for environmental liabilities at hundreds of hazardous waste sites throughout the United States.

The underlying claims differed not only in location but also in the type of pollution, the time span and the type of plant. Travelers allocated the settlement payments to a number of underlying insurance contracts and treated each site separately for facultative reinsurance purposes. This allocation permitted Travelers to successfully recover approximately $90 million of the settlement from facultative policies.

Travelers next sought an additional $21.4 million from the excess of loss treaty reinsurers by allocating the settlement payments to Koppers and DuPont as two single losses. As there is no prior U.S. case law on the issue of number of losses for reinsurance purposes arising from multiple pollution sites, Travelers used British case law to argue that settlement payment to each insured arose from a common origin: the insured's failure to properly administer their waste disposal at their respective plants nationwide.

The policies contained the standard reinsurance definitions for loss and disaster or casualty. Loss was defined as "all loss arising out of any one disaster and/or casualty under coverage of any or all insureds of the Companies." Disaster or casualty was defined as "each and every accident, occurrence and/or causative incident, it being further understood that all loss resulting from a series of accidents, occurrences and/or causative incidents having a common origin and/or being traceable to the same act, omission, error and/or mistake shall be considered as having resulted from a single accident, occurrence or causative incident."

The standard follow the fortunes clause stated: "Any and all payments made by [Travelers] in settlement of loss or losses under [that] policies, whether in satisfaction of a judgment in any Court against the Insured or [Travelers] or made voluntarily by [Travelers] before judgment, in full settlement, or as a compromise, shall be unconditionally binding upon [the reinsurers] and amounts falling to the share of the [reinsurers] shall be immediately payable to [Travelers]."

The court did not accept Travelers' rationale for treating each settlement as a single loss for treaty reinsurance purposes. The court explained that the plain language of the reinsurance contract states that to be one loss, the liability not only has to have a single cause or origin but must also be part of a series of such losses, that is, each of the pollution sites must have some sort of spatial or temporal relationship to each other. It is not enough to conclude that...
Measuring the Full Effects of Risk Financing Alternatives

In early November, Warren Buffet, CEO of Omaha, Nebraska-based Berkshire Hathaway, wrote to his shareholders about the company's third quarter results.

There are three basic rules in running an insurance company:

1. Only accept risks you are able to properly evaluate in your circle of competence and confine your underwriting to business that earns the expectancy of profit.
2. Limit the business accepted in a manner that guarantees you will suffer no aggregation of losses from a single event or from related events that will threaten your solvency.
3. Avoid business involving moral risk.

The basic purpose of capital is to protect a company against the risk of bankruptcy—i.e., to ensure that total liabilities do not exceed total assets.

Later in the same letter, Buffet continued:

"General Re is reemerging as underwriting practices and discipline with a new urgency to ensure that all three tests described earlier are met."

The events on September 11 have already propelled commercial insurance rates upward, and if Buffet's rules are adopted widely in the market, some reinsurers and their primary clients may find that they have to ration coverage, resulting in shortages of capacity for certain risks.

These developments may force a fundamental review of risk financing strategies, and many risk managers may need to re-justify risk adjusted return on capital (RAROC) analyses to evaluate alternatives, including reassessing the capital required to support the alternatives as well as the target and actual returns on that capital.

The first step in this process is measuring financial performance. Virtually all companies develop growth and profit targets, and most have translated these into return on capital (ROC), which—by adjusting for the debt portion of capital—can be translated into return on equity (ROE).

ROC is a guide to the most efficient allocation of a firm's capital among its business units and among alternatives for new investment. Actual and projected ROC is compared with the target return to ensure that it meets the expectations of the company's shareholders.

ROE is a key performance measure used by investors and analysts and is a driver of a company's stock price.

For use within an organization, as distinct from communicating with shareholders and security analysts, the allocated capital and target return should be computed for each business unit. Both of the following elements are adjusted for a particular kind of risk:

Capital allocation. The basic purpose of capital is to protect a company against the risk of bankruptcy—i.e., to ensure that total liabilities do not exceed total assets. Therefore, enough capital should be allocated to cover the financial impact of a selected proportion of adverse events that could impact the business. Such capital is called risk-adjusted allocated capital.

Target return. The target return is the rate that adequately compensates equity investors for the risks they assume, other than the risk of bankruptcy. A widely used method for determining the target return is the capital asset pricing model (CAPM), which derives the target return from three factors:

- the risk-free rate of return,
- the average premium normally required by investors, and
- an adjustment for the relative level of risk for a particular company or business.

For many companies, the vehicle for developing these parameters for individual business units is a multidisciplinary team. Some companies' teams may include the risk manager and incorporate the assessment of risk financing alternatives into the analysis. This makes addressing new risk financing alternatives easier.
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