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 million arising 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 $96 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 insureds' failures 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 [its] 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, thus, each of the pollution sites must have some sort of spatial or temporal relationship to each other. It is not enough to conclude that

The Mold Problem Expands

Source: Environmental Health & Engineering

- In a Mayo Clinic study of 210 patients with chronic sinus infections, mold was the cause of 93 percent of the infections in those studied. Previous prevailing medical opinion had pointed to mold in only 6 percent to 7 percent of cases.
- A newly constructed courthouse in Florida was closed because of mold contamination. The county filed suit against the contractor and was awarded $11.5 million.
- A Texas jury awarded a married couple a $32 million judgement against their insurance company for failing to act promptly on their claims of a mold problem.
- A California courthouse is the subject of a lawsuit brought by a district court judge and one hundred other employees for injuries allegedly caused by the fungus *Stachybotrys* resulting from defects in the air-conditioning system.
- Newer and newly renovated buildings appear to be more prone to mold and sick building syndrome problems because they are airtight.
- As a result of flooding in Texas this year, mold damage claims will account for nearly $500 million in additional costs for insurance companies.

the problems at all the sites were caused by poor companywide policy; each site must be treated as a separate loss, just as Travelers did with respect to its facultative reinsurers.

The follow the fortunes clause does not change the analysis. According to the court, the clause does not override the rest of the contract's terms and definitions; it requires the reinsurers to accept the insurer's judgment in paying the settlements. In Travelers' case, the reinsurers did not challenge whether the settlements were reasonable.

The court did not comment, however, on Travelers' disparate treatment of the loss to facultative and treaty reinsurers. Presumably, Travelers' argument was that the differing language of the reinsurance contracts required the disparate treatment, but the court had to notice that Travelers' contradictory interpretations resulted in the maximum recovery for Travelers from all types of reinsurance. This conflicting logic must have offended the high court's common sense.

The opinion suggests that consolidation of claims is possible if the insurer can establish some sort of relationship between the sites amounting to a series of losses from the same cause, e.g., if the same manufacturing process results in similar contamination or where the same types of tanks leaked. The trick will be establishing the relationship between the sites by admissible evidence without diminishing the insured's recovery under facultative reinsurance policies.

— *Richard Fogel*

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 (stay within your circle of competence) and confine your underwriting to business that . . . carries 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 revamping its underwriting practices and discipline with a new urgency to insure that all three tests described earlier are met."

The events on and following September 11 have already propelled commercial insurance rates further 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 employ risk adjusted return on capital (RAROC) analysis 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 analysis 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.

departments

Contributors

Lee Barnes ("Risk Reporter: Measuring the Full Effects of Major Risk Financing Alternatives," p. 8) is a principle of Greenwich, Connecticut-based Glenville Associates, serving as a management consultant to insurance and reinsurance companies and other financial institutions.

James A. Bruen ("Product Liability: The Role of the Product Steward," p. 34) is a partner with San Francisco-based Farella Braun & Martel LLP. He has over thirty years of criminal and civil litigation, and business accounting experience and has been selected by LegalElite to lead free e-mail seminars on different aspects of the law. (*jbruen@fbm.com*)

Nancy Chambers ("Executive Forum," p. 46) is the risk manager for the Waterloo Region Municipalities Insurance Pool, in Ontario, and vice president-treasurer of the Risk and Insurance Management Society.
(*nancy.chambers@city.kitchener.on.ca*)

J. Randall Davis ("Mock Trial: Sexual Harassment and Age Discrimination," p. 10) is a partner at Chicago-based Cassiday, Schade & Gloor. The firm specializes in the defense of product liability, employment law, transportation law and professional liability, including medical malpractice, insurance coverage and construction law cases. Davis represented the plaintiff in the mock trial presentation of *Peggy Peterson v. Discrimination Corp.* at REBEX 2001 in Chicago.

John D. Dempsey, CPA, CFE, ("Business Interruption, Part I: Re-Examining Business Interruption Insurance," p. 40) is the managing partner of Wilton, Connecticut-based Dempsey, Myers, and Company LLP, a nationwide CPA firm that specializes in preparing business interruption insurance claims. (*johndempsey@dempseymyers.com*)

Lee M. Epstein ("Business Interruption, Part I: Re-Examining Business Interruption Insurance," p. 40) is a partner with New York-based Fried & Epstein, a law firm specializing in the representation of policyholders in insurance coverage disputes.

Richard Fogel ("Risk Reporter," p. 7) is a partner with McMillan, Rather, Bennett & Rigano, P.C., located in Melville, Long Island. He counsels on commercial issues including contractual, litigation and insurance disputes. (*rfogel@mrbr.com*)

James A. Foster ("Mock Trial: Sexual Harassment and Age Discrimination," p. 10) is a partner with Chicago-based Cassiday, Schade & Gloor. Foster represented the defendant in the mock trial of *Peggy Peterson v. Discrimination Corp.* at REBEX 2001 in Chicago. (*jaf@cs-g.com*)

Michael T. Griffin ("Product Liability: Minimizing Manufacturers' Exposure to Corporate Criminal Liability," p. 30) is an associate with the Hartford, Connecticut-based Edwards & Angell LLP, a national law firm with one of the largest insurance and reinsurance practice groups in the United States. (*mgriffin@ealaw.com*)

Lloyd Hackett ("Legislative Forecast," p. 29) is RIMS' Canadian director of legislative, risk management and public affairs. He monitors federal and provincial legislative activity and works to raise the profile of risk management in Canada. (*cdrims@globalserve.net*)

Martha A. Pagliari ("Mock Trial: Sexual Harassment and Age Discrimination," p. 10) is a partner with Chicago-based Cassiday, Schade & Gloor. Pagliari played the role of the judge in the mock trial presentation of *Peggy Peterson v. Discrimination Corp.* at REBEX 2001 in Chicago.

Susan Rucker ("Enterprising Solutions," p. 6) is the national product director for KPMG LLP's Washington, DC-based Risk and Advisory Services. She has been working in the insurance industry for over twenty-three years. (*srucker@kpmg.com*)

Brian Schroeder ("Mock Trial: Sexual Harassment and Age Discrimination," p. 10) is an associate partner with Chicago-based Cassiday, Schade & Gloor.

Mark B. Seiger ("Product Liability: Minimizing Manufacturers' Exposure to Corporate Criminal Liability," p. 30) is a partner with the Hartford, Connecticut-based Edwards & Angell LLP. (*mseiger@ealaw.com*)

Jody Urquhart ("End Analysis," p. 48) speaks at meetings and conventions on how to build a passionate and committed workplace. She is the author of the book *All Work & No SAY*, which will be republished by Individual Excellence Group in September 2002. (*jody@idoinspire.com*)

Joanne Waldman ("Legislative Forecast," p. 28) is the government affairs manager at RIMS in New York. (*jwaldman@rims.org*)

RISK MANAGEMENT.

Publisher: Ted Donovan
Editor in Chief: Laura Sullivan
Managing Editor: Stephen Nickson
Associate Editor: Billie Swift
Art Director: Cate Behringer
Production Manager: Remo Salta
Circulation Manager: Callie Nelson
Director of External Affairs: Stephanie Orange

ADVERTISING SALES
NORTHEAST, SOUTH, INTERNATIONAL, BERMUDA AND CARIBBEAN
Ted Donovan
655 Third Avenue
New York, NY 10017-5637
212.655.5917 Fax: 212.655.2693
tdonovan@rims.org

MIDWEST
David Spindler
655 Third Avenue
New York, NY 10017-5637
212.655.6225 Fax: 212.655.6067
dspindler@rims.org

WEST COAST
Catherine Ann Woods
Mary Ann May
MediaWest
20 East Boca Raton
Phoenix, AZ 85022
602.863.2212 Fax: 602.863.6551
mediawest2@aol.com

CIRCULATION
Risk Management
P.O. Box 10568
Riverton, NJ 08076-8568
Customer Service: 856.303.0409
Fax: 856.786.4415

BPA INTERNATIONAL Member of

Editorial Advisory Council