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The Devil Is in the Details (Part II): Why the Terms in Your Insurance Policies Make a Difference

Article By:

Neil B. Posner

For both companies and individuals, insurance is a pervasive part of the business and legal environment. There are insurance products available to address nearly every conceivable risk facing businesses and their customers, ranging from first-party property, casualty and employee-dishonesty coverage, to traditional general liability, to management liability, errors and omissions and environmental liability, to off-shore wrap coverage for otherwise uninsurable risks. While this list is far from exhaustive, it illustrates the broad range of uncertainties against which a business can try to protect itself.

But planning to protect yourself from undesired loss involves more than identifying the type of insurance that generally fits a broad category of risks. As we discussed last month in "The Devil Is in the Details (Part I)," insurance policies are complex contracts. Seemingly minor variations in terminology can significantly alter the outcome of a claim for coverage. Last month's article also examined the consequences that can arise from certain differences in management liability insurance policies. That discussion was only the tip of the iceberg. Embedded in any standard-form insurance policy is a web of definitions, exclusions, conditions and representations that must be taken into account during the course of risk assessment, placement and claim management.

For example, all insurance policies necessarily require that a policyholder or beneficiary provide notice to an insurer of various events. Failure to do so can (and all too often does) result in there being no coverage for a claim that otherwise would have been covered. But the devil is in the details in ascertaining **when** notice is required, **what type** of notice is required, **by whom** notice must be provided and **how** notice is to be given. Disputes over compliance with notice requirements are a perennial subject of litigation and often are avoidable. Insureds should involve counsel at the earliest stages before deciding whether notice is necessary for the purpose of reducing the risk of a coverage dispute.

Equally important, every policyholder is different and has unique needs that may change over time. Companies in once-stable industries may find themselves facing unexpected challenges or a new wave of liabilities, and their insurance programs should be adjusted to reflect those realities. Similarly, as companies adapt to new ways of doing business, risks change, business plans and corporate practices evolve, the economic and litigation environments shift, and insurance programs must adjust to reflect ongoing developments.

The following case studies illustrate some of the ways in which variations in standard commercial policy terms—or the failure to coordinate coverage programs as a whole—can have dramatic consequences for policyholders.

Case Study 1: What Is an “Occurrence”

In July 2001, the long-term leaseholder of the World Trade Center agreed to bind $3.5 billion in limits of per-occurrence first-party property insurance coverage before there was firm agreement as to the terms under which that coverage would be bound and policies issued. In fact, there was little to suggest that the parties had given much, if any, thought to the terms and conditions that would apply. The underwriting files revealed that the dozens of insurers participating in the coverage had referred to multiple policy forms containing different and contrary definitions of "occurrence." As we now know, complete policies never were issued.

On the day after the devastating September 11 terrorist attacks, an insurance coverage dispute quickly arose: Was each plane hitting one of the towers a separate “occurrence” (which would mean that there were two sets of per-occurrence limits—totaling $7 billion—available to rebuild the towers) or were the attacks a single “occurrence” for which only one set of policy limits was available? There had been no discussion, much less agreement, as to which of the definitions of "occurrence" would apply. Therefore, the parties were left to argue their respective positions in protracted litigation in multiple courts based on the contradictory and fragmentary clues contained in the bids and coverage binders.

Case Study 2: Insolvency of a Fronting Insurer and Direct Access to Reinsurance

Primary comprehensive general liability (CGL) or workers compensation coverage is sometimes issued on a fronting basis. In a fronting program, an insurer admitted in a given state will issue a policy intended to conform to local law and then often will reinsure the entire policy. In this case, a workers-compensation fronting policy was issued by an insurer domiciled in a state where the insured had no operations or employees. The insurer, though reputable and long-established, became financially distressed because of adverse investment results. It then began issuing fronting policies as a means of generating fees while minimizing underwriting risk and administrative expenses. The policyholder was aware that all of the fronting policy's coverage obligations would be transferred to reinsurers but agreed with the arrangement because all the reinsurers were financially sound and had very good claims-handling reputations. In short order, the fronting insurer became insolvent and entered liquidation. But the policyholder was not worried because it assumed that it would be able to access the reinsurance directly. The liquidator in the state where the fronting insurer was domiciled, however, maintained that any reinsurance proceeds were assets of the insolvent estate, not of the out-of-state insured.

If the liquidator prevails, the policyholder will have to wait in line along with the insurer's other policyholders and creditors for a distribution from the insolvent insurer's estate. It is not unusual for the liquidation process to take longer than a decade, and payouts rarely exceed pennies on the dollar. In the meantime, the insured has ongoing obligations under various state workers-compensation regimes. Without access to the reinsurance, the insured effectively is self-insured and likely has to post substantial security to satisfy the authorities in the various states in which it operates. In the end, the dispute turns upon whether the fronting policy contained sufficient contractual "cut-through" rights allowing the policyholder direct access to the reinsurers.

Case Study 3: The Failure to Coordinate Excess Coverage

A company was found liable in an amount that exceeded the limits of its primary insurance, as well as several layers of its excess coverage. The primary insurer disputed coverage and would only settle the claim for an amount less than policy limits. The insured did not want to incur the expense and delay of litigating with its primary insurer while facing a sizeable loss. The company mistakenly assumed that, as long as it made up the difference between the settlement with the primary insurer and the limits of the primary insurance, it could rely on its umbrella and excess insurance coverage to pay the loss.

The various umbrella/excess policies differed as to when the underlying policies would be deemed exhausted. One excess policy provided that coverage did not attach until the underlying insurer paid its policy limits in full. Another stated that coverage attached once the underlying insurers *or the policyholder* paid loss in excess of the attachment point. Yet another provided that coverage attached when the policyholder incurred a liability in excess of the underlying limits of coverage. Because excess coverage was not coordinated before the inception of the program, this confusing thicket of irreconcilable terms led to protracted litigation that ended unfavorably for the policyholder.

Case Study 4: Is a Claim for Recall-Related Economic Loss or for Property Damage?

A wholesale food manufacturer unknowingly sold contaminated products that were incorporated by other manufacturers into packaged meals and placed on store shelves. Fortunately, the contamination was detected and all the meals were recalled before any consumers became ill. The policyholder's products, however, could not be removed without destroying the meals in which they had been used as ingredients. Thus, the contamination resulted in property damage to the other manufacturers' products. The policyholder had not purchased recall insurance because of its high cost. Additionally, its general liability insurance policies covered property damage caused by its products but excluded breach-of-contract claims and claims relating to a decrease in the value of property that incorporated defective materials produced by the policyholder. There was also an exclusion barring coverage for damages for the loss of use, withdrawal, replacement, removal or disposal associated with a recall.

In the end, the question of whether some portion of the liabilities incurred by the policyholder were insured depended in large part on how the purchasers presented their claims against the policyholder, over which the manufacturer had virtually no control.

Case Study 5: What Do My Internet Coverage Enhancements Cover?

An Internet company maintained a database that provided its users with a centralized repository of otherwise widely scattered public information. A hacker accessed the database and planted libelous statements that were transmitted to users until the company removed the offending content. The individuals about whom the harmful statements were transmitted subsequently sued the company.

The company's insurance policies contained a number of Internet coverage "enhancements," which it hoped would pay for the defense of the lawsuits. The company's general liability policy excluded coverage under the personal injury coverage part for statements transmitted over the Internet. The basic media liability policy provided coverage for liabilities arising from the policyholder's unintentional posting of false or libelous information on its database, but expressly excluded coverage for liabilities

arising out of the transmittal of statements inserted into the database by an unauthorized third party. An electronic-data-processing enhancement provided coverage for the expense of restoring data and operating systems if they were physically damaged but did not provide coverage for the expense of removing unwanted data. The cyber-liability enhancement to the media policy provided coverage for liabilities to third parties arising out of (1) the use of the policyholder's site as a conduit for transmitting viruses, (2) claims that an unauthorized third party had gained access to confidential or private information on the policyholder's website and (3) denial or impairment of access claims resulting from a third party's unauthorized interference with the site. The policyholder neither knew about, nor asked its broker about, other enhancements that more closely addressed the risks it actually faced and that eventually resulted in loss for the company.

Lessons Learned

Not all risks are foreseeable but, in each of these case studies, the policyholders would have benefited from treating the relevant insurance policies as significant commercial contracts with careful attention paid to three key issues:

1. The legal consequences of the defined, or in some cases undefined, policy terms;
2. The consistency of the program as a whole; and
3. The risks faced by the particular policyholder and the availability of form or manuscript terms responsive to those risks.

Consideration of these details can make all the difference between having coverage in place and being left responsible for a costly liability that could be detrimental—or even devastating—to your business.

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