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REBUTTAL: NY Joins Everyone Else On Insurance Allocation

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In the ongoing battle between the generally insurer-favored "pro rata" allocation method and the generally policyholder-favored "all sums" paradigm, insurers have long depicted New York as firmly on "Team Pro Rata." As a result, the insurance industry has been quick to deride the New York Court of Appeals' recent decision in Viking Pump Inc. and Warren Pumps LLC, ____ N.E.3d ____, 2016 N.Y. LEXIS 1018 (May 3, 2016), in which that court reaffirmed New York's place on "Team Policy Language," and held that insurance policies containing so-called "noncumulation of liability" provisions require application of an all sums allocation.[1] Timothy Kevane's recent Law360 guest article[2] depicting Viking as an inexplicable departure from the Court of Appeals' earlier pro rata allocation rulings and a "break" with an alleged nationwide "trend" toward pro rata allocation is therefore unsurprising — but totally at odds with the decision and the real "trend" of decisions addressing the issue that the Viking court actually confronted.

In fact, the court in Viking simply applied the plain policy language to the allocation issue and, in so doing, joined the *unanimous* chorus of courts outside New York holding that noncumulation provisions are irreconcilably inconsistent with pro rata allocation. It also implicitly rejected claims made by the insurers, and echoed by Kevane, that pro rata allocation is either "fair" or "efficient" when applied to policies containing such clauses — as indeed, it is not.

The Viking Decision Correctly Gives Effect to the Full Policy Language

Noncumulation provisions have a well-recognized purpose. They operate to prevent policyholders from "stacking" the limits of successive policies to satisfy their liabilities for a particular occurrence or, stated differently, to ensure that the policyholder will recover only one policy limit in a given insurance layer no matter how many policies are triggered.[3] But while these provisions limit coverage in many instances, they also recognize that the policy covers injury or damage that occurs outside, as well as within, the policy period — creating a direct conflict with pro rata methods, which operate from the assumption that the policy was intended to cover *only* that portion of a continuing loss relating to injury or damage "during the policy period."

For example, the noncumulation provisions in Viking either (i) expressly contemplated that the policy would provide full indemnity for "injury [that] occurs 'partly before and partly within the policy period'" or (ii) stated that the policy could cover the same "loss" as other policies that had been "'issued to the [insured] prior to the [policy] inception date.'"[4] The provisions thus "presuppose" that policies that

cover different time periods "may be called upon to indemnify the insured for the same loss."[5] That can never occur under a pro rata allocation, which assumes that a continuing loss is actually a continuing series of separate losses each attributable to a single policy period.[6]

Kevane complains that Viking "drain[s]" the "during the policy period" language "of any meaning." That is not so. Viking simply recognizes that "during the policy period" does not define the *scope* of the policy coverage where the policy contains a noncumulation provision. That language continues, however, to define which policies are *triggered* and available to respond to particular third-party claims.[7]

Notably, it was the *insurers* in Viking who advocated for an interpretation that would excise language from the relevant policies. As the court noted, the insurers "originally argued ... that the noncumulation clauses should not be given effect in a pro rata allocation."[8] Only after recognizing that such an approach "would conflict with [New York] principles of contract interpretation" did the insurers reverse course to argue that noncumulation provisions are consistent with pro rata methods.[9]

Viking Aligns New York with the Law of Other Jurisdictions

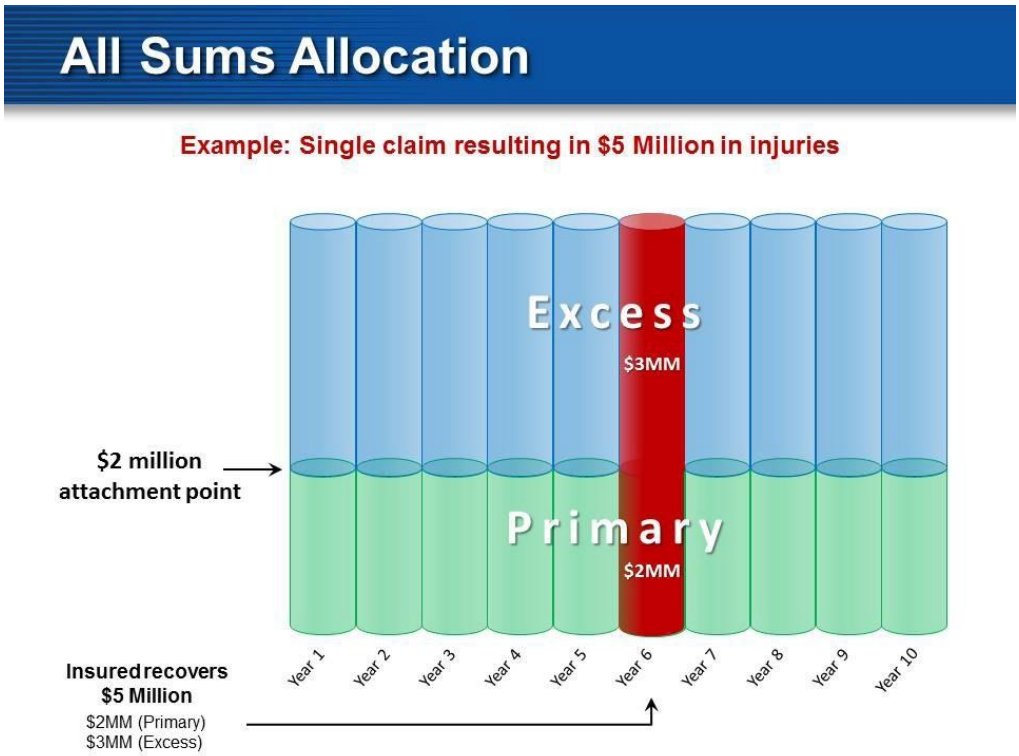
Contrary to Kevane, the decision in Viking did not "break" with a "prevailing trend" in favor of pro rata allocation. In fact, while courts are divided on whether the "during the policy period" language is consistent with an all sums or pro rata standard, there is no such dispute as to the effect that noncumulation clauses have on the appropriate allocation method. Every court outside New York to address the issue — including the highest courts of Delaware, New Jersey, Wisconsin and Massachusetts[10] — has recognized that noncumulation provisions are incompatible with pro rata allocation. For example, Kevane cites to the pro rata allocation ruling in Boston Gas, but fails to note that Massachusetts' highest court actually stated in that case that it would have reached a different allocation result had the relevant policy contained a noncumulation provision, as "such a provision is inconsistent with pro rata allocation because it expressly provides for coverage outside the policy period."[11]

There is Nothing Fair About Applying Pro Rata Allocation to Noncumulation Policies

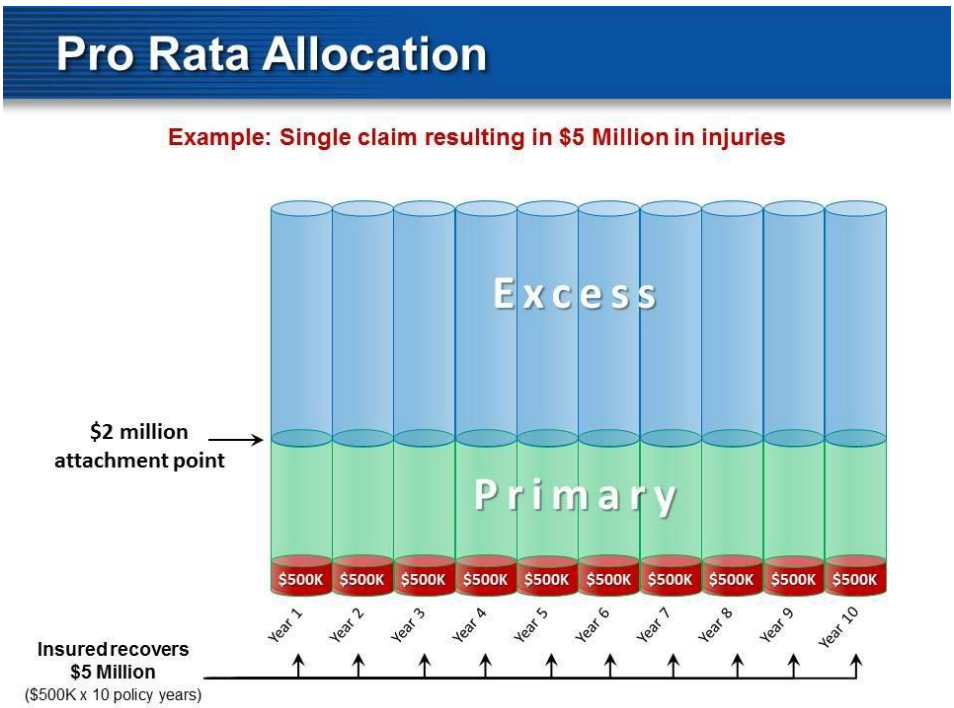
Kevane also attacks Viking for abandoning the "fairness" and "efficiency" that he attributes to pro rata methods. At the most basic level, this entire line of argument is irrelevant because true "equity" consists in holding contracting parties to the bargains they have made.[12] Insurers who included noncumulation provisions in their policies — and invoke those provisions whenever it serves their interests to do so — cannot reasonably complain when policyholders enforce their side of the bargain.

But even if it were otherwise, the record in Viking shows that it is anything but "fair" or "efficient" to impose a pro rata methodology on policies that contain noncumulation provisions. Aware that the New York Court of Appeals had already held that noncumulation provisions are enforceable under New York law,[13] the insurers did not argue to that court (as they had earlier in the Delaware proceedings) that the provisions should simply be disregarded. Rather, they contended that noncumulation provisions properly can operate within a pro rata allocation.[14] To illustrate their position, the insurers provided the court with a hypothetical, which posited that a $5 million judgment had been entered against a policyholder on a claim that triggered 10 policy years, each covered by a $2 million primary policy with a noncumulation provision and overlying excess policies.[15]

As Chart 1 shows, the policyholder would recover the full amount of the judgment under an all sums/noncumulation approach simply by assigning all of its losses to one policy year.

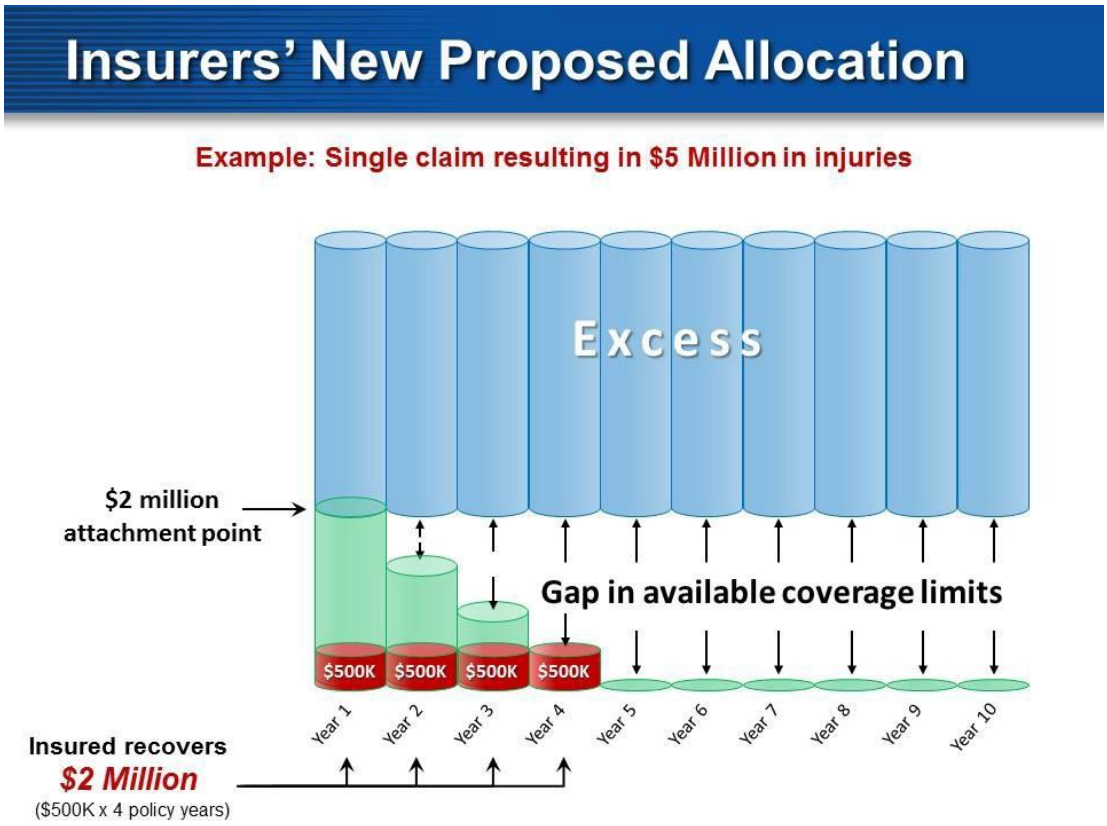


The policyholder would also recover the full judgment amount under a pro rata allocation method if the noncumulation provisions are disregarded. Under that scenario, the $5 million loss would be spread evenly across all 10 policy years, and the policyholder would collect a $500,000 payment from each triggered policy.



The insurers' proposed "hybrid" methodology would, however, effect a *60 percent reduction in coverage*

for the judgment. Under that methodology, (i) the judgment would first be prorated in equal shares to the 10 triggered policies, resulting in a $500,000 allocation to each policy and (ii) noncumulation provisions would then be applied to reduce the $2 million "each occurrence" limit in later-issued policies by amounts paid under earlier policies.[16] As a result, the insurer would pay $500,000 under each of the first four policies but would owe nothing under the six remaining policies, leaving the policyholder to recover the unpaid $3 million balance, if possible, from overlying excess policies.[17]



Plainly, nothing about this result is "fair." On the one hand, the policyholder recovers only 40 percent of the $5 million judgment amount even though it is insured throughout the period of injury and has purchased $20 million in applicable primary insurance limits. On the other hand, the primary insurer will not pay a dime for injuries that occurred during years five through 10 even though it collected premiums to provide insurance protection throughout that six-year period. In short, under the Viking insurers' interpretation, the primary insurer would receive precisely the "double credit" and windfall that has led courts to uniformly reject the simultaneous application of noncumulation provisions and pro rata allocation.[18]

As importantly (and as Chart 3 also illustrates), application of the insurers' proposed methodology would create massive gaps in insurance coverage between different insurance layers. Under the insurers' hypothetical, no primary policy would pay more than a fraction of the full $2 million "per occurrence" limit toward the judgment and most policies would pay nothing at all. In these circumstances, overlying excess insurers would almost certainly deny coverage for the unpaid losses on the ground that none of the relevant primary policies had "exhausted." Excess insurers have argued with much success that their obligations do not attach unless and until the relevant underlying insurers have paid out the full, stated limits of all directly underlying policies.[19] Thus, and at the very minimum, the insurers' "hybrid" methodology would generate widespread litigation over the existence and scope of excess insurers'

obligations to pay amounts that fall within underlying policy limits but are not payable by underlying insurers.[20]

Kevane fails to address any of these points, nor does he otherwise seek to reconcile noncumulation provisions with pro rata allocation. Instead by closing his article with the suggestion that courts should apply pro rata allocation on "public policy" grounds and irrespective of what the relevant insurance contracts provide, he actually reverts to the Viking insurers' initial, rejected position: that courts should read noncumulation clauses out of the policies to accommodate pro rata allocation. The vast majority of American courts, however, undoubtedly subscribe to the Viking court's contrary view that, in all but the most exceptional circumstances, courts should honor the contracting parties' expectations by enforcing insurance contracts in accordance with their terms.[21] Those courts can also be expected to follow Viking in holding that policies with noncumulation provisions provide coverage on an all sums basis.

—By John P. Winsbro and Elizabeth A. Sherwin, McKool Smith PC

DISCLAIMER: McKool Smith represents Warren Pumps LLC in this matter.

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[1] 2016 N.Y. LEXIS 1018, at *10.

[2]See "Viking Pump Rebels Against NY pro rata Allocation Regime" (May 19, 2016)

[3] See 2016 N.Y. LEXIS 1018, at * 15.

[4] Id. at * 17, 19.

[5] Id. at *19.

[6] Id.

[7] See Viking Pump Inc. v. Century Indemnity Co., 2 A3d 76, 121 (Del. Ch. 2009) (ruling that, when it is read in conjunction with the noncumulation provisions, "'during the policy period' simply requires that the insured's liability be attributable to an occurrence [or injury]' during the policy period and not that the liability did not result at all from events outside the policy period.")

[8] 2016 N.Y. LEXIS 1018, at *20 n.6.

[9] Id.

[10] See Hercules v. AIU Insurance Co., 784 A.2d 481, 493-94 (Del. 2001); Spaulding Composites Co. v. Aetna Casualty & Surety Co., 819 A.2d 410, 422 (N.J. 2003); Plastics Eng'g Co. v. Liberty Mutual Insurance Co., 759 N.W.2d 613, 625-26 (Wis. 2009); Boston Gas Co. v. Century Indemnity Co., 910 N.E.2d 290, 309-10 (Mass. 2009).

[11] 910 N.E.2d at 309. Kevane asserts that Olin Corp. v. American Home Assurance Co., 704 F.3d 89 (2d Cir. 2012), "reconciled" pro rata allocation with noncumulation provisions. In actuality the Olin court reached a result that is antithetical to any pro rata method, holding that the policy there covered losses arising from 22 years of post-policy period property damage.

[12] See, e.g., J.P. Morgan Sec. Inc. v. Vigilant Insurance Co., 21 N.Y.3d 324, 334 (2013)

[13] See, e.g., Hiraldo v. Allstate Insurance Co. 5 N.Y.3d 508 (2005)

[14] See generally Brief for Respondents (Oct. 8, 2015) ("Insurer Br.") at 20-34.

[15] See id. at 25.

[16] See id. at 27-28.

[17] See id.

[18] See, e.g., Spaulding, 819 A.2d at 422 (applying noncumulation provisions in a pro rata allocation would unfairly "insulate ... insurers who were actually 'on the risk' ... from their fair share of liability" for injuries that occurred during their policy periods).

[19] See, e.g., Forest Labs. Inc. v. Arch Insurance Co., 116 A.D.3d 628 (1st Dep't 2014).

[20] The insurers in Viking suggested that the excess insurers in their hypothetical might "respond to the excess loss" if "the excess policies' specific policy language" provided for such a result. See Insurer Br. at 28-29. But, despite being ideally situated to do so, the insurers never identified any excess policy anywhere which provides for the excess insurer to pay losses directly above policy limits that have been reduced by the operation of noncumulation provisions.

[21] See 2016 N.Y. LEXIS 1018, at *13.
