Expert Commentary

Coverage Gaps Created by Exclusionary Endorsements

For several years, insurers have added proprietary restrictive or exclusionary endorsements purported to be "Montrose" like or "anti-stacking" endorsements to the Insurance Services Office, Inc. (ISO), commercial general liability (CGL) coverage form.

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Liability Insurance

Often described as an attempt to restrict coverage to one policy period, at first glance, these endorsements may seem fair or even harmless. Yet, such restrictive endorsements too often leave the policyholder uninsured, particularly for bodily injury or property damage that is progressive, cumulative, or continuous. (For more on Montrose, see the September 2014 article in this column, "The Montrose Endorsement—15 Years Later.")

The following discussion explains why these endorsements may leave substantial gaps in general liability coverage.

The Prior Work Exclusion

Applying the Prior Work Exclusion. A residential plumbing contractor was busy installing plumbing systems at various residential condominium construction projects in the 1990s into year 2000 and beyond. Upon renewal in the early 2000s, the CGL insurer for the plumbing contractor added to the policy a "prior work exclusion" endorsement. When specifically asked if the "prior work exclusion" created a gap in coverage, the underwriter wrote to the plumber's insurance broker, representing that no gap in coverage was created because "the policy of record when the work was done would be triggered" in the event of bodily injury or property damage.

A typical prior work exclusion endorsement, which is not an endorsement promulgated by ISO, typically states:

> This insurance does not apply, and the Company shall have no duty to defend any claim or "suit" seeking damages for "bodily injury" or "property damage" arising out of "your work" completed prior to the date shown in the Schedule of this endorsement.

In the mid-2000s, a year or so after the "prior work exclusion" was added to the plumbing contractor's CGL policy, a fixture installed by the contractor in the late 1990s failed, resulting in water damage to the surrounding property. When the plumbing contractor tendered the water damage claim to their current CGL insurer, a denial of coverage quickly followed.

The current insurer asserted that the plain meaning of the "prior work exclusion" was that the policy did not provide any coverage for work performed before the date listed on the exclusionary endorsement. As the plumbing fixture that failed was work completed *before* the date scheduled on the "prior work exclusion" endorsement, the CGL policy at the time the property damage occurred *excluded* coverage.[1] Further, the CGL policy in effect at the time of the installation did not provide coverage, as the property damage did not occur

during that policy period. Despite purchasing consecutive CGL coverage policies with no break in coverage, the plumbing contractor had no coverage for its property damage claim under any CGL policy—a gap in coverage.

A Persistent Misunderstanding. The CGL policy in effect when the work was done will always provide coverage regardless of when the resulting bodily injury or property damage takes place is a commonly but mistakenly held notion by some in the insurance industry and many outside of the insurance industry. Coverage applies if and only if the bodily injury or property damage *occurs during the policy period*. Nonetheless, this misunderstanding continues to persist, resulting in coverage gaps in a wide variety of situations, including the gap in coverage usually created by the "prior work exclusion." (For more on what triggers the CGL policy, see the October 2006 article, "The Hazards of Products and Completed Operations: Understanding the Fundamentals.")

American Institute of Architect (AIA) 2017 Changes. The AIA's A201™ -- 2017 General Conditions of the Contract for Construction now provides for use of a separate insurance exhibit: AIA Document A101™ 2017 Exhibit A Insurance and Bonds. This exhibit (Exhibit A) is intended to be used in conjunction with A201, article 11, and specifically prohibits certain exclusions from the contractor's CGL policy, stating the CGL policy "... shall not contain an exclusion or restriction of coverage for the following: ... ".5 Claims or losses excluded under a **prior work endorsement** or other similar exclusionary language." [Emphasis added.]

Prior Injury or Damage Exclusion

While the actual name of the exclusionary endorsement often varies, the intent is generally the same—if bodily injury or property damage *commences* before the inception of the policy, the exclusion applies to any bodily injury or property damage that resumes or continues during the policy period. Here is typical non-ISO wording for such an endorsement:

> This insurance does not apply to:
>
> Any "bodily injury" or "property damage," whether known or unknown by any insured, which first occurred or commenced prior to the inception date of this policy. We shall have no duty to defend any insured alleging damages arising out of "bodily injury" or "property damage" to which this endorsement applies.

Not Montrose Wording. Insurers may describe this endorsement as being "Montrose" like. Any such characterization is a misinterpretation of the purpose of the so-called Montrose wording. The "Montrose" endorsement (which was incorporated into the ISO CGL insuring agreement in the 2001 edition) only applies to *known* injury or damage. The insurance industry's prime concern about the Montrose ruling was that it

effectively allowed coverage for what the insurance industry believed was a known loss or a known loss in progress. This is because Montrose Chemical knew *prior to the policy period* that property damage and bodily injury were taking place.

ISO's response was drafting and incorporating into the CGL policy the Montrose wording, which limits coverage only *after* certain insureds become aware that bodily injury or property damage is progressively occurring. In short, excluding bodily injury or property damage that has commenced before the inception of the policy, but which is unknown to any insured, is decidedly not "Montrose" like and is not the equivalent of the ISO Montrose wording.

Anti-stacking. Insurer's may also characterize exclusions applicable to unknown bodily injury or property damage that begins before the inception of the policy as anti-stacking or intended to keep the damages payable to one policy period. While such an explanation may accurately describe the prior injury or damage exclusions, it does not take into account the gap in coverage that may result.

Insurers tend to presume that a policyholder may "load up" all of the damages into the single CGL policy that is triggered, and the policyholder would then have no valid need to "stack" the coverage provided in the policy periods that exclude unknown prior bodily injury or property damage. While anti-stacking may have an intuitive appeal, the method of allocation of damages over multiple policy periods in which bodily injury or property damage continues to occur may well result in uninsured damages. In other words, in order to avoid a gap in coverage, the policyholder may very well need to stack coverage over consecutive policy periods to protect against bodily injury or property damage that resumes or continues to occur during those policy periods.

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Allocation of Damages

Courts usually determine how to allocate damages between or among CGL policies when continuous bodily injury or property damage occurs during multiple CGL policy periods.

> The method of allocating damages for latent bodily injury and property damage claims, sometimes called long-tail or continuous injury or damage claims, **is critical and determinative question of law that may substantially impact the amount of an insurance company's liability under a commercial general liability (CGL) policy**.[2] (Emphasis added.)

There are two basic approaches that courts apply (each with numerous nuances) to the allocation of damages—the "all sums" (also known as "joint and several" or "pick and spike") and the "pro rata" method.

All Sums Allocation. In the "all sums" approach, the courts generally allow the policyholder to choose which policy year to target, and to "load up" all damages from all years in which bodily injury or property damage took place into one policy year. In the "all sums" method, the policyholder may also be allowed to "go vertical" (or "pick and spike") into the excess liability layers. Here is a general example of "all sums":

> Coverage under Markel's policy is limited to property damage that occurs during the policy period but expressly includes damage from a continuous exposure to the same harmful conditions. **For damage that occurs during the policy period, coverage extends to the "total amount" of loss suffered as a result, not just the loss incurred during the policy period**. No question remains that all 465 houses at issue suffered property damage during the policy period, which began before or during the policy period and continued until it was repaired, all because of water trapped in home walls by EIFS applied to wood frame construction. Thus, the policy covered Lennar's total remediation costs. (Emphasis added.)

Lennar Corp. v. Markel Am. Ins. Co., 413 S.W.3d 750 (Tex. 2013)

Insurers tend to assume the "all sums" method of allocating damages is available to all policyholders in all states, but that is not the case.

Pro Rata Allocation. In the "pro rata" method, the court does not allow the policyholder to choose the policy to pay but instead allocates the damages over the entire period of time the bodily injury or property damage has been occurring. A common "pro rata" method is "pro rata time on risk," in which the damages are allocated over the time bodily injury or property damage was occurring and uninsured damages are allocated to and are the responsibility of the policyholder—thus the potential gap in coverage. Here is a recent example:

> As we discussed in part III A of this opinion, in *Security,* our Supreme Court adopted a pro rata allocation method for adjudicating long latency loss claims that implicate multiple insurance policies. *Security Ins. Co. of Hartford* v. *Lumbermens Mutual Casualty Co.,* supra, 264 Conn. 720. Under the pro rata approach, defense and indemnity costs are allocated among insurers on the basis of their time on the risk, but are allocated (prorated) to the insured for periods during which the insured lost or destroyed its policies or was otherwise uninsured or underinsured.

R.T. Vanderbilt Co., Inc. v. Hartford Accident & Indem. Co., 171 Conn. App. 61 (March 7, 2017)

However, the proration formula may be applied differently to those policy periods when insurance was not commercially available:

> The primary rationale that other courts have offered in favor of the unavailability rule is that the justifications that support prorating costs to a policyholder during periods of self insurance or underinsurance simply do not apply when insurance is not commercially available. We therefore conclude that the cases that have adopted an unavailability rule are better reasoned, represent the majority position, and more closely comport with our Supreme Court's analysis in *Security.* Accordingly, it was not improper for the trial court to exclude Vanderbilt from the allocation block for years in which asbestos related insurance was unavailable.

R.T. Vanderbilt Co., Inc. v. Hartford Accident & Indem. Co., 171 Conn. App. 61 (March 7, 2017)

While some insurers may believe the damages excluded by the prior injury or damage exclusion would fall in the category of commercially unavailable insurance, that is an unlikely result. Many insurers in the marketplace do offer CGL coverage without excluding unknown bodily injury or property damage that began prior to the inception of the policy.

Further, some states that apply "pro rata, time on risk" allocation will allocate damages to all periods in which the bodily injury or property damage occurred, even if insurance was not available during those periods.[3]

Application of Each Approach—An Illustration

Policyholder X has purchased three consecutive CGL policies with annual policy periods from the same insurer: Insurer A.[4] The first CGL is Policy Year 1, the second CGL is Policy Year 2, the third CGL is Policy Year 3. Assume all three CGL policies include the prior injury or damage exclusion endorsement and that each occurrence limit on each of the policies is $1 million. Policyholder X has also purchased an excess/umbrella policy in Policy Year 1 only with a limit of $2 million.

Also assume water intrusion has begun at customer's premises in the first policy year and is undiscovered until the third policy year. The total damages over the 3 policy years is determined to be $1.2 million. All three policies have been triggered here.

All Sums Allocation. This method would allow Policyholder X to choose Policy Year 1 to pay its policy limit of $1 million and then "go vertical" ("pick and spike") and choose its excess/umbrella to pay the $200,000 of damages that exceeds the CGL policy limit. Based on the facts provided, Policyholder X can "load up" all of the damages for the 3 years into one policy year (Policy Year 1) and thus Policyholder X will be fully compensated and have no uninsured damages.

Pro Rata Allocation. This method does not allow Policyholder X to choose the CGL policy that will pay its damages. Rather, under the pro rata approach, time on risk, the court will allocate the damages evenly over the 3 years—$400,000 per year.

The result will be that Policy Year 1 will pay the damages the court has allocated to that policy year—$400,000—as the property damage had not begun before inception of Policy Year 1.

However, Policy Year 2 and Policy Year 3 will both deny coverage—the property damage from which the damages arose commenced *before* the respective policy periods, and, therefore, the property damage is excluded by each CGL policy. Policyholder X will be compensated for damages only for the first year: $400,000, but will be *uninsured* for the remaining damages allocated to Policy Year 2 and Policy Year 3: $400,000 per year or $800,000 in total uninsured.

Prior Injury or Damage Exclusion Combined with Pro Rata Allocation

As can be plainly seen, when the pro rata approach is applied to the above fact pattern, Policyholder X needs coverage in all three policy periods in order to avoid a gap in coverage. The use of the prior injury or damage exclusion (when combined with pro rata allocation of damages) leaves Policyholder X uninsured for $800,000 in damages. This outcome is too often overlooked when it is assumed the policyholder always has the option of "loading up" all damages into the CGL policy year in which coverage is not excluded. In other words, the use of the prior injury or damage exclusion to avoid stacking may have unintended consequences, leaving the policyholder a substantial gap in coverage and significant uninsured damages.

Noncumulation Endorsement

Another approach to prevent stacking of consecutive CGL policies is the noncumulation endorsement. While not an endorsement promulgated by ISO, the noncumulation endorsement is routinely attached to CGL policies by a few national insurers. But the endorsement applies only when the *same* insurer provides CGL coverage in multiple policy years (in the above illustration of "all sums" and "pro rata," we assumed the same insurer provided CGL coverage for all 3 policy years).

The endorsement generally states that if more than one CGL policy has been issued by that insurer (in our example Insurer A), the limit on any policy on which the noncumulation endorsement is attached will be reduced by amounts paid under the other CGL policies issued by that insurer.

Pro Rata Allocation Illustration. In our pro rata approach illustration above, presume all three CGL policies for Insurer A included the noncumulation endorsement[5]. Policy Year 1 would pay the full amount of damages allocated to that policy year: $400,000. The Policy Year 2 limit would be reduced by $400,000 (therefore, a $600,000 limit is now applicable), and Policy Year 2 will also pay the full amount of damages allocated to that policy year: $400,000. The limit for Policy Year 3 will be reduced by the payments made under the 2 prior policy years—the limit in Policy Year 3 is now reduced to $200,000 due to the noncumulation endorsement. As the damages allocated by the pro rata method to Policy Year 3 are $400,000, Policyholder X would be uninsured by $200,000.

Because the noncumulation endorsement only applies to multiple policies with the *same* insurer and it is not an exclusionary endorsement (rather, it reduces the limit available), the effect of this endorsement tends to be less harsh than the prior injury or damage exclusion.

However, the result of the noncumulation endorsement depends almost entirely on the damages payable for each policy year. For example, if the damages payable were $3 million allocated (pro rata) as $1 million to each policy year, Policyholder X would be uninsured for $2 million.[6] On the other hand, if the damages were actually $900,000 allocated over 3 years, the noncumulation endorsement does not result in uninsured damages (the $600,000 paid in total for Policy Year 1 and Policy Year 2 would leave a limit in Policy Year 3 of $400,000, enough to pay the actual damages of $300,000 allocated to Policy Year 3).

Conclusion

Policyholders should be wary of restrictive or exclusionary endorsements that are purported to be like "Montrose" or endorsements that are "anti-stacking" (or endorsements that are purported to restrict the damages payable to a single policy period).

The purpose here is not to explain the details and variations in each of the two basic approaches courts employ in the allocation of damages. Nor is this article intended to compare or contrast the relative merits, based on CGL policy wording, of the "all sums" or the "pro rata" approach to the allocation of damages. Instead, the intent is to shed some light on insurer "anti-stacking" endorsements when considering the implications of court-imposed allocation of damages over multiple policy periods.

In order to avoid characterizing the above noted CGL coverage gaps created by "anti-stacking" endorsements as resulting from extraordinary or unusual applications of the law that have little effect on most policyholders, consider this: "... the majority of state high courts expressly rejecting the 'all sums' method in favor of the pro rata allocation method...."[7]

In other words, the "pro rata" approach to the allocation of damages should not be dismissed as an aberration or a peculiarity of one or two state courts. It may be the majority of policyholders with the above "anti-stacking" endorsements will have a built in but undiscovered gap in CGL insurance policies.

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[1]The underwriter's e-mail could not be used in the litigation to contradict the plain meaning of the "prior work exclusion."

[2]Randy Maniloff and Jeffrey Stempel, *General Liability Insurance Coverage—Key Issues in Every State*, Third Edition (Matthew Bender & Company, 2015), pg. 597.

[3]*Boston Gas Co. v. Century Indem.*, 910 N.E.2d 290 (Mass. 2009) at 297

[4]The outcome would be the same even if three different insurers provided the CGL policies for each policy year.

[5]The outcome would be the same if only Policy Year 3 included the noncumulation endorsement.

[6]If the noncumulation endorsement was added only to Policy Year 2 and Policy Year 3, the outcome would be the same—$2 million uninsured damages. If the noncumulation endorsement was added only to Policy Year 3, the uninsured damages would be $1 million.

[7]Randy Maniloff and Jeffrey Stempel, *General Liability Insurance Coverage—Key Issues in Every State*, Third Edition (Matthew Bender & Company, 2015), pg. 598.
