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Perspective

Watch for exposures in integration

Multiyear programs may benefit policyholders, but they can result in unintended problems

By Marc S. Mayerson

OVER THE PAST TWO YEARS, there has been a dramatic increase in the availability of "integrated risk" solutions for companies wanting to insure a variety of exposures in one product. Last year, capacity in this market reportedly exceeded $500 million. Integrated risk products are not entirely new, and several larger companies, aided by the leading American and London market brokerage houses, began utilizing such programs at least by the early 1980s.

What has changed over the past year or so is the expansion of capacity and the relative ease of access that substantial companies now have to integrated risk products. Since late 1995, we have seen the introduction of the Swiss Reinsurance Co. BETA program, the Risk Solutions program sponsored by X.L. Insurance Co. Ltd. and CIGNA Corp., and analogous products from American International Group Inc., Chubb Corp. and others.

Though integrated risk programs always are tailored to the needs of the buyer, they share several features:

- First, disparate coverages are combined into a single program. Accordingly, a single program may include combinations of general liability, property, hull, cargo, fidelity, crime, employment practices, errors and omissions and workers compensation lines, among others. For this reason, integrated risk programs are also called "cross-class" programs.

Integrated risk programs also can include harder-to-place lines, such as product recall or tampering, political risk or environmental liability.

- Second, integrated risk programs involve multiyear contracts and few insurers, and these contracts can take the form of direct writing or reinsurance of a captive.
- Third, integrated risk programs often utilize a single overall aggregate for all hazards, though some of the lines included in the integrated risk program may retain entirely separate limits.

Integrated risk programs have considerable advantages, and the expansion of capacity—albeit in a soft market—bodes well for the continued availability of this risk management tool. Notwithstanding the dramatic expansion in capacity, many companies purchase additional excess coverage for at least some lines covered by the integrated risk program.

It behooves all involved in the insurance community to think through some of the issues surrounding the combination of integrated and monoline policies today rather than face legal battles later.

A medical device manufacturer, for example, might well want to purchase additional limits for its product-liability exposure. Thus, integrated risk programs are more likely than not to be only partial; that is to say most companies will have an integrated risk program up to a certain dollar limit and then have individual policies providing additional limits sitting atop the integrated risk program on a monoline basis.

This combination of integrated risk and monoline coverage has the potential to create mischief when the policyholder presents a claim involving sufficient dollars as to warrant a "strategic" response by the monoline insurer or insurers. It behooves all involved in the insurance community—policyholders, brokers and insurers—to think through some of the issues today, at the point of underwriting, rather than to face the otherwise inevitable battles in court at the point of claim. Those issues include:

- **Problems with underlying exhaustion.** A monoline policy sitting on top of an integrated risk program will set forth an underlying limit that must be reached before the policy has an obligation to respond. In more traditional programs, where a high-level carrier is sitting on top of a column of policies, in theory at least one exhausts layer by layer up the column seamlessly. The problem with an integrated risk/monoline program is that the underlying integrated risk layer can be exhausted by claims wholly outside the monoline coverage. Thus, the integrated risk layer may be validly and appropriately exhausted by the payment of fidelity, property, workers comp and other claims, such that when a products claim comes along there is no more available coverage. The policyholder in such circumstances naturally would turn to its next higher layer carrier, in this instance a monoline carrier, and request performance. That carrier may well take the position, however, that its obligation to perform is not ripe, because its underlying limit has not been reached.

In other words, the monoline carrier writing products coverage excess of a $100 million integrated program may take the position that $100 million of products claims must be paid before it performs. If the underlying layer is an integrated risk program that has been exhausted by property and other losses, the policyholder faces the prospect of having to fill the gap itself. In other words, due to the exhaustion outside of the monoline carrier's coverage, the policyholder may be exposed to self-insuring an amount up to the underlying limits.

• **Non-contemporaneous exhaustion.** Where the integrated risk program's limits apply on a multiyear basis and where the monoline carrier's policy period is not co-extensive with the integrated risk layer—e.g., the monoline is an annual contract—one has to be careful that the overlying monoline carrier will recognize exhaustion under the integrated risk layer that occurs for events/injury/claims outside its policy year.

In other words, if the integrated risk layer is written for three years and the overlying monoline policies are written on annual contracts, the overlying carrier may not recognize that its lower limit has been penetrated where the events/injury/claims for which payment has been made occur outside of its policy year.

Again, the policyholder in this situation has validly exhausted its integrated risk layer, but due to the mismatch in policy years, the overlying monoline carrier may well not recognize the exhaustion outside of its annual period as counting toward satisfying its underlying limit. Thus, the policyholder may face an uninsured gap under which it may be required to pay additional amounts for events/injury/claims in the monoline carrier's year before that carrier will respond.

• **Mismatched triggers.** Another problem with a combined integrated risk and monoline program is that the triggering provisions may not be identical. For example, the integrated risk program might be written on a claims-made basis and the monoline policy might be written on a reported-occurrence basis. In such a circumstance the policyholder is exposed to this problem: A few claims come in during the first integrated-risk period, and these turn out to be the start of serial, repetitive products-liability claims. After receiving a number of these claims, the policyholder determines that it potentially faces a big problem and, thus, declares an occurrence under its reported-occurrence excess monoline policies. The excess reported-occurrence carrier could take the position that an earlier integrated risk period must pay all claims in the series up to the integrated-risk policy limits and that its own underlying limits are not exhausted by the payment of the policy limits in the earlier period. In this scenario, the policyholder is exposed to paying for an amount equal to the underlying limits of the later reported-occurrence policies out of its own pocket (of course only after the integrated risk insurers in the earlier period have paid their remaining policy limits).

There are several approaches to dealing with the problem of the ordering of policy exhaustion with a program that blends integrated risk and monoline policies.

• **What to do.** These problems concerning the ordering of exhaustion when integrated risk and monoline programs are combined surely are not sufficient to justify abandoning the integrated risk approach, if it otherwise makes sense. The point here is that the virtue of the integrated risk program can also be its chief vice when it is combined with excess monoline policies.

In addition to arguing that extant policy language already avoids this problem, there are at least three other approaches to managing the risks concerning exhaustion described above.

First, the policyholder can negotiate with its monoline insurers and have them agree that exhaustion of the applicable integrated risk layer constitutes underlying exhaustion for purposes of the monoline policies. This type of agreement should recognize that exhaustion can occur both for hazards completely outside of the coverage of the monoline carrier and for losses occurring in different policy periods where the coverage is non-contemporaneous or where there are differing triggers under the integrated risk and monoline programs.

Second, the policyholder can negotiate with its integrated risk insurers and have them agree to a reinstatement of limits provision for hazards covered by excess monoline policies. Under this approach, once there is some or complete exhaustion of the integrated risk layer, the insured can buy-up its limits to the level of the applicable monoline carriers' lowest underlying limit.

Third, the policyholder can accept the risk of uninsured gaps (and the policyholder in reality may have no choice but to accept this risk for the integrated-risk or the monoline carriers may not favorably respond to the either of the above options). Accepting the risk, willingly or not, does not suggest not planning for the uninsured gap. Rather, the policyholder could as part of its comprehensive risk management program establish some form of a difference in conditions/difference in limits program to fill in the gap when or if it occurs. Such a DIC/DIL program could be created simply by accruing reserves over time, by purchasing a DIC/DIL policy through some alternative market, or by accessing capital markets to fund the gap.

Integrated-risk programs appear here to stay-at least for a while. Good risk-management principles dictate that the company address the problem of marrying integrated risk programs with monoline excess coverage now, before claims have come in and before the problem of actual or asserted gaps arises.

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