Much (Allocation) Ado About Nothing: IMO Decision Presents Such Unique Facts the Court Resists Offering General Allocation Law Pronouncements

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When, on July 6, 2015, the New Jersey Supreme Court declined to grant certification and review the Appellate Division's published and unpublished rulings in *IMO Industries Inc. v. Transamerica Corp.*, it brought to a conclusion more than a decade of litigation over the responsibility for plaintiff IMO Industries Inc.'s asbestos liabilities.[1] The Court declined to disturb rulings that IMO's former parent and co-insured, Transamerica Corporation, was not obligated by its divestiture agreement with IMO or its consolidated risk management approach (purchasing insurance for itself and its then wholly owned subsidiaries, including IMO) to pay IMO's asbestos losses or to pay for gaps in insurance for IMO's asbestos liabilities.

The Court also confirmed the exhaustion of IMO's primary insurers, requiring IMO to turn to its (and Transamerica's) excess insurers for defense and indemnity of its asbestos losses. Moreover, and perhaps more importantly, the Supreme Court's ruling offered closure regarding the treatment of the unique allocation and exhaustion issues, which had been closely watched by risk managers, policyholder and insurer lawyers, and insurance companies to the extent they might bear more generally on New Jersey's allocation law regarding defense costs.

The Appellate Division recognized that aspects of this issue had not been previously addressed by New Jersey Supreme Court rulings, but it ultimately declined to make any general pronouncements. It instead limited its ruling because of the intensely factual nature of the parties' disputes.

IMO involved (among many other things) various questions relating to New Jersey's allocation law as set forth in *Owens-Illinois, Inc. v. United Insurance Co.*[2] and *Carter-Wallace, Inc. v. Admiral Insurance Co.*[3] But these issues arose in the context of primary insurers that had already paid their policies' full limits, and declared exhaustion, under pre-*Owens-Illinois* interim funding agreements with IMO. After the last primary insurer, TIG Insurance Company, had already paid more than $30 million, IMO sought a reallocation of losses under *Carter-Wallace*. IMO then alleged that TIG was not exhausted, if one accepted IMO's theories relating to allocation of payments (not allocation of loss) and the impact that the timing of an insurer's prior, actual payments under the interim funding agreements should have on a later reallocation of loss.

The Appellate Division, in addressing the matter, was focused on exhaustion and the allocation of defense costs under *Carter-Wallace* to a primary insurance policy with a supplemental defense obligation (*i.e.*, the policy pays defense costs in addition to the stated indemnity limit). The trial court ruled—here, where the reallocation of loss was to an insurer that had already paid (and indeed, overpaid) its limits—that the allocation of defense costs to such policies ceases when the policy is allocated losses up to its limit.

IMO appealed this ruling, urging that defense costs should be retroactively reallocated to a policy even after that policy has been allocated its full indemnity limits, and even where indemnity costs were then being simultaneously allocated to other excess insurance policies. This allocation of 'extra' defense costs was, according to IMO, appropriate because on the reallocation of defense costs the allocation should end not on reaching indemnity limits but continue beyond it (and be based upon the actual payment of the losses). Although the Appellate Division affirmed the trial court, it neither endorsed nor rejected the trial court's ruling that payments are

irrelevant to allocating defense costs to an insurer. Instead, the Appellate Division found that the insurer's supplemental defense obligation was terminated by exhaustion through actual payment of policy limits and did not reach the question of whether the defense obligation can end based solely on an allocation of loss.

IMO's argument was not intended simply to secure some additional coverage for its indemnity losses, but rather to obtain millions of dollars in additional defense costs. IMO posited that if the policies were not exhausted by actual (prior) payment, then the policies with a supplemental defense obligation should continue to be reallocated defense costs, even long after the policies had been allocated their full limits in indemnity and the excess policies were triggered. Thereby, IMO sought to collect an additional $48 million (and counting) in defense costs from five defense outside of limits primary policies with indemnity limits of only $1 million each.

As the Appellate Division acknowledged, the allocation of defense costs "ha[s] not been previously addressed in the New Jersey Supreme Court's allocation decisions."[4] *Owens-Illinois* and *Carter-Wallace* adopted an allocation methodology for long-tail claims (such as asbestos) of *pro rata* by time, weighted by policy limits. The allocation model calculates percentages for each policy period, which determine the amount of loss allocated to those policy periods. Supreme Court allocation decisions repeatedly applied the methodology to indemnity, but never defense costs. The trial court's ruling in *IMO* may have tread on new ground, but the Appellate Division emphasized that it would not provide "general conclusions" regarding allocation of defense costs because "the exhaustion decision in this case is closely tied to its facts."[5] Indeed, the facts of *IMO* are so unique they are unlikely to be replicated by any other policyholder in New Jersey. For example, the trial court found, and the Appellate Division affirmed, that IMO's own unclean hands precluded IMO from prevailing on its exhaustion and allocation of defense costs arguments.[6]

To understand the courts' rulings, it is necessary to understand a bit about IMO's insurance coverage. There were 10 general liability policies in dispute between IMO and the involved primary insurer, TIG. These policies provided coverage from 1977 through 1986. During this time period, IMO, a manufacturer of industrial pumps and turbines (some of which contained asbestos) was a subsidiary of defendant Transamerica Corporation. TIG, also a Transamerica subsidiary at the time, issued these policies covering Transamerica and all of its subsidiaries, including IMO. These 10 policies often were referred to as fronting policies because upon their issuance Transamerica entered into separate agreements with TIG whereby Transamerica agreed to indemnify TIG for certain losses paid under the policies. The term "fronting policies" also distinguished these 10 TIG policies from those TIG issued directly to IMO (but not Transamerica and subsidiaries) in the 1960s and 1970s (the direct policies).

The fronting policies had total limits of $10.75 million. The first five fronting policies were defense outside of limits policies, and the latter five were ultimate net loss policies (also known as defense inside limits policies), for which payment of defense costs erodes policy limits. IMO never disputed that the five ultimate net loss policies were exhausted. Its focus was on the fronting policies with the supplemental defense obligation.

When IMO was first sued in asbestos litigation, and for 17 years after, IMO's asbestos claims were handled and paid by its primary insurers, including by TIG under the fronting policies and direct policies, until the fronting policies exhausted by the end of 2003. Through 2003, TIG had paid $30.1 million on its policies (and Transamerica had reimbursed TIG $15.9 million for the fronting policies under the indemnity agreements). Indeed, Transamerica's reimbursements alone were sufficient to have fully paid the $10.75 million in limits on the fronting policies. When notified that the TIG primary policies were exhausted, IMO rejected this view and sued TIG and its former parent, Transamerica.

Throughout the course of the litigation, IMO posited a number of different theories to justify its position that the fronting policies were not exhausted, but each of those theories was either abandoned by IMO or soundly rejected by the court. For example, IMO's original theory was that Transamerica and/or TIG was liable for IMO's losses because the fronting policies had a never-ending retention into which all of IMO's losses would fall, and which its former parent, Transamerica, or its primary insurer, TIG, was responsible to pay. Transamerica prevailed on summary judgment that there was no such retention. Then, at trial, IMO proposed that the fronting policies were not exhausted (and thus owed tens of millions of dollars in supplemental defense costs)

based on IMO's allocation of payment (not loss) theory, and also by the timing of TIG's payments under the interim funding agreements. The trial court, however, concluded that the fronting policies were not only exhausted, but that TIG had overpaid on those policies.

IMO had taken the position at trial that TIG's $15.9 million in payments should be allocated among the fronting policies using *Carter-Wallace*-like percentages. Under IMO's theory, some policies would be allocated payments far greater than their limits, leaving other policies underpaid. The trial court, unconvinced that TIG could not apply its own payments to its own policy's limits, applied the overpayment amounts to the underpaid policies to conclude the fronting policies were exhausted (and overpaid). On appeal, IMO argued that applying overpayments to underpaid years violated *Carter-Wallace*'s prohibition on horizontal exhaustion. The Appellate Division disagreed, explaining that horizontal exhaustion involves exhausting all primary policies before triggering excess policies, a situation simply not present here.

IMO also sought to demonstrate the TIG policies were unexhausted by urging, without success, that TIG's payments toward the fronting policies were somehow late. By way of background, in the early 1990s, IMO and its insurers entered into interim funding agreements that assigned fixed shares of IMO's defense and indemnification to the insurers and IMO. The agreements predated *Owens-Illinois*, and instead of using an *Owens-Illinois*-like allocation method, the agreements assigned equal shares to each participant, regardless of the number of policies or amount of coverage issued by each. In 1998, IMO was approached about applying the then recently decided *Carter-Wallace* decision to IMO's asbestos losses, but "IMO's General Counsel strongly disagreed with *Carter-Wallace*[,] refused to apply its methodology," and was content to remain operating under the agreements.[7] Thus, TIG paid IMO's asbestos losses under the agreements until the exhaustion of the fronting policies by the end of 2003.

Four years into the litigation, however, IMO reversed its position and moved for an order retroactively applying a *Carter-Wallace* allocation to all of IMO's asbestos losses, even those already paid by TIG under the interim funding agreements. The retroactive application of *Carter-Wallace* in 2008 allocated *less* losses in total to the fronting policies than TIG paid under the funding agreements, but, at least initially, allocated those losses to the fronting policies more quickly than TIG had paid under the funding agreements. The five defense outside of limits policies were retroactively allocated losses up to their full indemnity limits as early as 1999 and 2000. Although TIG's payments through 2003 were, undeniably, more than enough to exhaust the fronting policies, those payments were not made as quickly, in the early years, as the after-the-fact *Carter-Wallace* allocation would have required.

IMO relied on this alleged timing anomaly to argue the fronting policies were not exhausted, and that the five defense outside of limits policies should be assigned all defense costs allocated to those five policy periods. TIG responded that after a policy is allocated its full indemnity limits, the excess policy above is triggered and allocated all subsequently incurred indemnity costs; the defense costs should follow the allocation of indemnity to the excess policy, rather than requiring the primary policy to pay the defense costs for a claim that is covered by excess policies. The trial court rejected IMO's theory, concluding that IMO's reasonable expectations and the degree of risk transferred to the fronting policies required that defense costs be allocated to the defense outside of limits fronting policies only until they had been allocated their full indemnity limits in losses. IMO's theory, the trial court concluded, was inconsistent with the dictates of *Owens-Illinois* and *Carter-Wallace*.

The Appellate Division affirmed the trial court, finding its allocation decision allocated defense costs "in general conformity with the risks transferred to those policies."[8] The court explained that "TIG made payments in good faith" under the funding agreements, and the "fact that the timing of TIG's payments failed to coincide with loss allocations as calculated later was simply an accident of the development of the pertinent law."[9] Moreover, the timing discrepancy between the retroactively applied *Carter-Wallace* allocation and TIG's actual payments under the funding agreements "was also a product of IMO's refusal to allow a *Carter-Wallace* allocation at an earlier time to replace the [funding agreements]."[10] This attempt by IMO to penalize TIG with $48 million of extra defense costs as a result of IMO's own change in position prompted the trial court to rule that IMO had unclean hands, precluding it from pursuing its novel theories for additional defense costs.

Despite its general affirmance of the trial court, the Appellate Division did not explicitly address whether the supplemental defense obligation of a defense outside

of limits policy could be terminated through an allocation of loss regardless of payment. Instead, it focused on the reality of TIG's payments (indeed, overpayments):

> There is no dispute that TIG made *payments* that exceeded the aggregate of its *Owens-Illinois* and *Carter-Wallace* allocations. So we can say its policies were exhausted not just by allocation, but by allocation combined with payments that exceeded the total amount allocated to TIG.[11]

Moreover, the court explained that because the allocation of loss to the fronting policies reached the policies' limits, TIG's payment of the allocation satisfied the policy limits as well:

> Once the indemnity limits of the fronting policies were reached by allocation, and the prior aggregate payments from TIG exceeded those allocations, TIG's coverage was exhausted.[12]

Because the Appellate Division concluded TIG's actual payments exhausted the fronting policies, the court did not reach the question of whether the supplemental defense obligation can terminate based solely on the allocation of loss when payments have *not* been sufficient to exhaust the policy.

Thus, the predicate to IMO's position—that TIG's payments were insufficient to exhaust the fronting policies—was rejected by the Appellate Division, and the rest of IMO's theory collapsed. True to its word, the Appellate Division did not provide a "general conclusion" on the termination of the defense cost obligation of an outside the limits policy in a *Carter-Wallace* allocation. Rather, the court concluded: "In this case, producing a proper allocation pursuant to *Owens-Illinois* and *Carter-Wallace* requires that the fronting policies be construed to have been *exhausted by allocation and aggregate payment* by TIG that exceeded the policy limits."[13]

The factual circumstances and novel arguments offered by IMO were unique and complex—retroactive reallocations, overpaid policies, unclean hands, etc. For that reason, the *IMO* decision offers little guidance beyond that the allocation approach set forth in *Owens-Illinois* and *Carter-Wallace* remains applicable and unchanged, and any lingering issues relating to allocation of defense costs remain to be answered (but not by *IMO*). ■

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Endnotes

1. *IMO Industries Inc. v. Transamerica Corp.*, 437 N.J. Super. 577 (App. Div. 2014) *certif. denied* 222 N.J. 16 (2015).
2. *Owens-Illinois, Inc. v. United Insurance Co.*, 138 N.J. 437 (1994).
3. *Carter-Wallace, Inc. v. Admiral Insurance Co.*, 154 N.J. 312 (1998).
4. *IMO*, 437 N.J. Super. at 588.
5. *Id.* at 609.
6. *Id.* at 612-13.
7. *Id.* at 596.
8. *Id.* at 611.
9. *Id.* at 612.
10. *Id.*
11. *Id.* at 610 (emphasis added).
12. *Id.* at 611.
13. *Id.* at 612 (emphasis added).