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The Pro Rata Clause, the Prisoner's Dilemma, and Unintended Consequences

by Tyler Thompson¹

Introduction

A pro rata clause "limits the insurer's liability to payment of the portion of the loss that the face amount of the policy bears to the total insurance available on the risk." *Black's Law Dictionary* (8th ed. 2004). The amount each insurer must pay depends upon the pro-rata. *Commercial Union Ins. Co. of New York v. Farmers Mut. Fire Ins. Co. of St. Louis County*, 457 S.W.2d 224, 227 (Mo.App. 1970).

Insurers include these clauses in insurance policies to limit their exposure if multiple policies from multiple insurers cover the same event. Generally, a pro rata clause appears within or is intricately linked with an "other insurance" clause, the latter of which, no matter how worded (e.g., "this insurance shall be excess over any other insurance"), may nevertheless be interpreted to require a pro rata distribution of available insurance proceeds.

Suppose a business's building is burned down in a fire. The business is the named insured under its own insurance policy, and an additional named insured under the landlord's insurance policy. Both policies will cover the fire and render the insurers' obligations "several" because the policies are no longer under a common burden. *Id.* They are liable only for the percentage they are assigned to pay; they are not liable for the same burden. As such, one insurer no longer has a right of contribution against any of the other insurers. (At least, that is the conclusion reached in the Missouri case of *Commercial Union* cited above.)

These points of law were the subject of *Mid-Continent Ins. Co. v. Liberty Mut. Ins. Co.*, 236 S.W.3d 765 (Tex. 2007). Though the case originated in Texas, insurance industry professionals and insurance law practitioners in Missouri and Illinois will recognize the scenario presented in the case.

Facts and Judicial Analysis

In 1996, Kinsel Industries was the general contractor on a highway project. *Id.* at 769. Two cars collided within Kinsel's construction zone, resulting in severe injuries to the plaintiffs in the underlying action. *Id.* at 768.

Liberty covered Kinsel under a comprehensive general liability policy as the named insured. *Id.* at 769. Mid-Continent covered Kinsel under another policy as an additional named insured. *Id.* Each policy contained a pro rata "other insurance" clause. *Id.* Each policy also had a \$1 million policy limit. *Id.*

Both insurers cooperatively assumed the defense of the claims against their common insured. Nonetheless, Mid-Continent refused to contribute more than \$150,000 to settle the case, despite Liberty's demands that Mid-Continent contribute \$750,000 toward what Liberty saw as a \$1.5 million case (in terms of settlement value). *Id.*

Liberty eventually settled with the plaintiffs on Kinsel's behalf for \$1.5 million, finding itself in the position of having to cover \$1.35 million of the agreed settlement despite its \$1 million policy limit. *Id.* at 770. Liberty then filed suit against Mid-Continent, seeking reimbursement to the extent Liberty paid more than its 50% pro rata share of the settlement.

In reviewing the case, the Texas Supreme Court assumed, for purposes of its analysis, that Mid-Continent had "unreasonably" valued the case. *Id.* at 768. Nevertheless, the court concluded Mid-Continent owed no duty to Liberty, and Liberty was not entitled to any reimbursement from Mid-Continent. *Id.* at 772. Liberty did not have an equitable contribution claim against Mid-Continent; having pro rata clauses in the

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¹A debt is owed to the authors of *Game Theory and the Law* for the idea of applying the prisoner's dilemma in legal situations. See Douglas Baird, Robert Gertner, and Randal Picker, *Game Theory and the Law*, Harvard University Press (1994). **PLEASE NOTE** this article is the work of Tyler Thompson alone, and not that of Sandberg Phoenix & von Gontard P.C. or any of its clients. The article is intended to spark the reader's interest and apply theoretical concepts from other disciplines to analyze a set of facts and various outcomes as presented in a judicial opinion.

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policies precluded any such claim. *Id.* at 773. Additionally, Liberty did not have a subrogation claim against Mid-Continent because Liberty would be required to stand in the insured's shoes in a such a claim. *Id.* at 775. Here, the insured (Kinsel) was fully indemnified by the \$1.5 million settlement and had no right to enforce Mid-Continent's alleged duty to pay its pro rata share of a loss. *Id.* Therefore, because Liberty was required to stand in Kinsel's shoes, it could not enforce Mid-Continent's duty. *Id.*

Application of Game Theory to the Facts

The facts of *Mid-Continent* present an opportunity to apply game theory in the realm of insurance law. Game theory is typically thought of as an economic theory, but has been applied in a number of disciplines, including the social sciences. It attempts to capture the behavior of parties in strategic situations in which the decisions of one party are based on the decisions of one or more other parties.

A number of strategic models are used in game theory, from the simple to the complex. Models can be used to predict single interactions between two parties, in which neither party anticipates further interaction (i.e., a typical lawsuit), as well as multiple repeated interactions (i.e., an ongoing contractual relationship).

Here, despite the likelihood that Mid-Continent and Liberty (institutional "players" in the insurance arena) will have to interact again at some point in the future, the facts approximate a single interaction. The valuation of a claim is a fact-specific enterprise, dependent on the specific happenings and details of the individual case. As such, this situation can be viewed as a single interaction between the two parties. Additionally, for reasons further discussed below, *Mid-Continent* can be examined as a case involving the "Prisoner's Dilemma," one of the simplest game theory models.

The story of the "Prisoner's Dilemma" is a familiar one, even to those who have never studied game theory. Two criminals are captured and are under suspicion for the same crime. The prosecutor has a serious charge against the criminals, with a lesser one available. The prosecutor needs the confession of one of the criminals to convict the other of the more serious charge.

Choices and Options, Rewards and Repercussions

In exchange for a confession, the prosecutor will let the confessing criminal go free (a result of zero years in prison, the best available result under the circumstances), will be able to convict the other one of the serious charge, and will be able to obtain the maximum sentence against him (a result of ten years in prison, the worst result under the circumstances).

If both criminals confess, the prosecutor will choose to give each some leniency, but will be able to convict both of them of the more serious charge (a result of six years in prison for each). If neither criminal confesses, the prosecutor will rely on independently obtained evidence that is only strong enough to convict the criminals of the lesser offense (a result of two years in prison for each).

A table representing the choices available to the criminals and the number of years each criminal spends in prison (based on the options available to and chosen by the prosecutor, as described above) appears below.

		Criminal 2	
		Silent	Confess
Criminal 1	Silent	-2, -2	-10, 0
	Confess	0, -10	-6, -6

We can develop a similar table under the facts arising in *Mid-Continent*, with the choices available to each insurer being to (1) "reasonably value" the claim (or, stated differently, cooperate with the other insurer in arriving at a realistic valuation); or (2) "unreasonably value" the claim and try shifting the burden of payment (or the majority of that burden) to the other insurer. The results of the insurers' choices are shown in thousands of dollars paid on the claim.

		Liberty	
		Reasonably Value Case	Unreasonably Value and Shift Burden
Mid-Continent	Reasonably Value Case	-750, -750	-1350, -150
	Unreasonably Value and Shift Burden	-150, -1350	-1000, -1000

This table is not meant to fully parallel the "Prisoner's Dilemma" table; it is adjusted to fit the facts of *Mid-Continent*, with hypothetical values inserted for the alternative scenarios not arising in the case. These hypothetical values involve (1) both insurers reasonably valuing the claim; and (2) both insurers unreasonably valuing it and attempting to shift the burden of payment to the other side, in which case a judgment against both insurers for policy limits or more is returned, and each ends up (again, hypothetically) paying its policy limits.

In game theory, the "Prisoner's Dilemma" is an example of a sub-optimal game. Each player anticipates the other will defect (i.e., confess or, as applied to the facts of *Mid-Continent*, unreasonably value the case and try to shift the burden of payment).

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In such a situation, all other things being equal, the players will more often than not defect, even though they would both be better off by cooperating. One experiment has found that when people are offered this type of choice, they choose to cooperate approximately 40% of the time (and thus not cooperate 60% of the time). Amos Tversky, *Preference, Belief, and Similarity: Selected Writings*, MIT Press (2004).

Shifting the Analysis to Missouri and Illinois

Under Missouri law, a pro rata clause has been held to preclude an insurer's ability to obtain contribution from other insurers. *Commercial Union*, 457 S.W.2d at 227. This rule of law makes working with other insurers in arriving at a realistic valuation of a claim a sub-optimal game, as in the "Prisoner's Dilemma" and the *Mid-Continent* scenario.

Why is the process sub-optimal? The "players" do not have the choice of reasonably valuing a claim and then pursuing the other insurer ("player") that did not do so. As such, ironically, under the rule stated in *Commercial Union*, using a pro rata clause in an attempt to limit liability may result in an insurance company finding itself in a classic "Prisoner's Dilemma," which may result in paying policy limits (a repercussion that can result if both companies "unreasonably" value a claim and are unable to cooperate to obtain a favorable result).

Illinois, however, has adopted a different approach. In *Home Ins. Co. v. Cincinnati Ins. Co.*, 821 N.E.2d 269, 276 (Ill. 2004), it was held that "[c]ontribution as it pertains to insurance law is an equitable principle arising among coinsurers which permits one insurer who has paid the entire loss, or greater than its share of the loss, to be reimbursed from other insurers who are also liable for the same loss." Under this rule, unlike the *Commercial Union* rule, an insurer may reasonably value a claim and later pursue reimbursement from a coinsurer that did not do so. In other words, under the *Home Ins. Co.* rule, the insurer does not face a "Prisoner's Dilemma."

Conclusion, and Practical Application

This author emphatically does not intend to motivate or encourage insurance companies to revamp or remove pro rata clauses in their insurance policies. In practice, such clauses are not only often useful; they are also necessary to avoid being saddled with 100% of the exposure when other insurance is available. Additionally, certain external or intangible factors may motivate insurers to be more cooperative than the economic and social science research may predict.

Instead, this article merely demonstrates that unintended results may occur when including policy provisions that are intended to limit liability. The article also shows how state law can affect

the "rules of the game," as when comparing the rules stated in *Mid-Continent* and *Commercial Union* with those stated in *Home Ins. Co.* Insurers should not only be aware of but also systematically track and document (to the extent possible and practical) the effect such policy provisions and rules of law may have—not only on their relationship with insureds, but also on their relationships with other insurers.

Recent Missouri and Eighth Circuit Insurance Cases of Note

Insurer doesn't get "second bite at apple": after agreeing to defend underlying suit without reservation of rights, the insurer cannot contest coverage in subsequent garnishment action.

In *Kinnaman-Carson v. Westport Ins. Corp.*, 283 S.W.3d 761 (Mo. banc 2009), an injured motorist and her spouse successfully sued the owner of a vehicle, then filed a petition for equitable garnishment against the owner's insurer. The accident occurred after an unauthorized third party had taken the owner's vehicle and collided with the motorist's vehicle.

The Missouri Supreme Court had to decide whether an insurer could contest coverage in a garnishment action despite its agreement to defend the underlying tort suit without reserving its rights. At the time the insurance company agreed to defend the underlying suit, a judgment had already been entered against the insured it had agreed to defend. The court held the insurer was barred from contesting coverage in the garnishment action because it had made no attempt to appeal the underlying judgment or have the judgment set aside. The Court said the insurer should not be allowed to get a second bite at the apple by contesting coverage in the garnishment action.

Insurer not entitled to reimbursement of previously advanced defense costs, and insureds not entitled to reimbursement of attorney's fees and expenses incurred after insurer's initial denial of coverage.

In *Westchester Fire Ins. Co. v. Wallerich*, 563 F.3d 707 (8th Cir. 2009), a case decided by the Eighth Circuit applying Minnesota law while relying on cases from Missouri and other states, a property development company obtained a business and management indemnity insurance policy that included a directors, officers, and company indemnity coverage (D&O) section. Two investors in the company filed a lawsuit in Minnesota state court against three officers of the company, alleging breach of

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various fiduciary duties in connection with the management and auction of certain residential and commercial properties held by the company.

The sued officers timely notified the insurer of the lawsuit and sought coverage. The insurer denied coverage and refused to defend the sued officers, whose counsel then urged the insurer to reconsider its position. The insurer changed its position and agreed to defend subject to a full reservation of rights, including the right to seek reimbursement of defense costs and expenses in the event a court found no duty to defend. The sued officers objected to the insurer's reservations, but accepted its offer to advance funds for their defense costs and expenses.

The insurer then filed a declaratory judgment action in federal district court, seeking a determination that it owed no coverage and was entitled to reimbursement for the attorney's fees and expenses incurred in defending the underlying suit. The sued officers counterclaimed for attorney's fees and expenses incurred as a result of the initial denial of coverage and for defending the declaratory judgment action. The district court found the insurer had no duty to defend or indemnify, but also found the insurer was not entitled to reimbursement for defense costs and expenses because the policy contained no agreement to reimburse. Additionally, the court found the sued officers were entitled to attorney's fees and expenses of more than \$6,300.00.

Both the insurer and the sued officers appealed. Among other things, the insurer appealed the award of more than \$6,300.00 to the officers, and the denial of any reimbursement for defense costs. The officers appealed the finding that there was no duty to defend or indemnify them.

On the question of reimbursable defense costs, after an in-depth review of several cases from various jurisdictions, including Missouri, the Eighth Circuit noted simply that the policy did not include a provision or agreement entitling the insurer to such a reimbursement, and the court did not find it appropriate to apply quasi-contract or unjust enrichment theories. Finally, the court reversed the award of attorney's fees and expenses to the officers because there never was coverage in the first instance; as such, there can be no recovery for such fees and costs.

Recent Illinois Insurance Cases of Note

Insurer unable to meet burden of proof to show boys entrapped in excavation pit died from single occurrence; thus \$2 million aggregate limit applied, not lower per-occurrence limit.

In *Addison Ins. Co. v. Fay*, 905 N.E.2d 747 (Ill. 2009), two young men died of hypothermia following their entrapment in an excavation pit on the insured's property. The insurance company filed a

declaratory judgment action seeking to have the two deaths declared a single occurrence, such that a per-occurrence policy limit of \$1 million would apply, rather than the \$2 million general aggregate limit.

The Illinois Supreme Court held the insurer could not sustain its burden of proof to show the deaths were so closely linked in time and space to constitute a single occurrence. The evidence presented at trial permitted an inference that the boys did not become trapped simultaneously. More particularly, the evidence supported an inference that one boy became trapped while attempting to rescue the boy initially trapped. Therefore, the deaths would not be treated as a single occurrence, and the general aggregate limit applied.

False pretenses exclusion applied, such that insurer had no duty to indemnify auto dealer under business protection policy for manager's embezzlement.

In *Joe Cotton Ford, Inc. v. Illinois Emcasco Ins. Co.*, 906 N.E.2d 1279 (1st Dist. 2009), an auto dealer's manager transferred possession and title of approximately 75 vehicles over a period of several years, and arranged for the proceeds (approximately \$1.25 million) to be deposited into personal accounts.

The dealer filed a declaratory judgment action seeking a determination that the insurer had a duty to indemnify it for its loss under its business protection policy. The insurer filed a motion for summary judgment, arguing the dealer's claims were barred by a false pretenses exclusion, which barred recovery for a "loss" to a "covered auto" resulting from "someone causing you to voluntarily part with it by trick or scheme or under false pretenses." The dealership's misplaced trust in its employee went to the heart of the false pretenses exclusion. Accordingly, the First District upheld summary judgment for the insurer based on the application of that exclusion.

27-month delay in providing written notice of defamation suit to CGL carrier breached prompt-notice provision of policy and precluded coverage, regardless of any prior actual notice.

In *West American Ins. Co. v. Yorkville National Bank*, 902 N.E.2d 1275 (3d Dist. 2009), the commercial general liability (CGL) insurance policy at issue contained a provision requiring the insurer to "receive written notice of the claim or 'suit' as soon as practicable." The insured did not provide the insurer written notification of a defamation suit until 27 months after initiation of the suit. Also, the written notice arrived when discovery was closed and two months before a jury trial was scheduled to commence. As such, the late notice violated the provisions of the policy as a matter of law, and the insured was not entitled to coverage, despite any actual notice of the claim the insurer may have had.

PLEASE NOTE THAT on May 28, 2009, the Illinois Supreme Court allowed an appeal to be taken in this case. At the time of publication, the matter was still before the high court.

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