Simpson Thacher

Insurance Law Alert

December 2018

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Finding Exception To Finality Rule, Second Circuit Rules That Arbitrators Retain Authority To Clarify Ambiguous Award

The Second Circuit recognized an exception to *functus officio*, ruling that when an arbitration award is ambiguous, the arbitrators retain authority to clarify that award. *General Re Life Corp. v. Lincoln National Life Ins. Co.*, 2018 WL 6186078 (2d Cir. Nov. 28, 2018). (Click here for full article)

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– *Chambers USA* 2018 (quoting a client)

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The Eighth Circuit affirmed an Arkansas district court decision certifying a class of homeowners who allege that State Farm improperly withheld amounts for labor depreciation when making claim payments. *Stuart v. State Farm Fire & Casualty Co.*, 2018 WL 6358447 (8th Cir. Dec. 6, 2018). (Click here for full article)

Simpson Thacher News Alert

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Damages Alert:

Damages For Insurer's Breach Of Duty To Defend Not Capped At Policy Limits, Says Nevada Supreme Court

The Nevada Supreme Court ruled that when an insurer breaches its duty to defend, damages are not capped at policy limits; rather, an insurer may be liable for any consequential damages caused by the breach. *Century Surety Co. v. Andrew*, 2018 WL 6609591 (Nev. Dec. 13, 2018).

The coverage dispute arose out of an automobile accident involving a truck that was used by the driver for both personal and business use. Century provided commercial liability insurance to Blue Streak, the driver's employer. Century refused to defend Blue Streak in the underlying personal injury litigation on the basis that the driver was not acting within the scope of his employment at the time of the accident. After the parties to the underlying litigation settled, the injured party, as assignee of Blue Streak, sued Century, alleging breach of contract and bad faith.

A Nevada federal district court ruled that Century breached its contractual duty to defend but did not act in bad faith. As to the scope of permissible damages, the court certified the following question to the Nevada Supreme Court:

> [w]hether, under Nevada law, the liability of an insurer that has breached its duty to defend, but has not acted in bad faith, is capped at the policy limit plus any costs incurred by the insured in mounting a defense, or [whether] the insurer [is] liable for all losses consequential to the insurer's breach.

The Nevada Supreme Court noted that the majority of courts have concluded that where there is no bad faith, damages are ordinarily limited to the amount of policy coverage, plus attorneys' fees and costs. However, the court adopted the minority view, holding that damages arising from a breach of the duty to defend are not automatically capped at policy limits plus defense costs. The court reasoned that the "objective is to have the insurer 'pay damages necessary to put the insured in the same position he would have been in had the insurance company fulfilled the insurance contract.'" Thus, a party aggrieved by an insurer's refusal to defend may be entitled to recover all consequential damages flowing from that breach, including any underlying judgment, plus interest.

Importantly, the court noted that a policyholder is not automatically entitled to recover the entire underlying judgment as a consequence of the insurer's breach. Rather, the policyholder must establish that an insurer's breach of the duty to defend caused an excess judgment.

Arbitration Alerts:

Last month's Alert discussed a New York appellate court decision that vacated a "corrected" arbitration award because the panel exceeded its authority by reconsidering a final award it had previously rendered. In that decision, the court held that: (1) the corrected award violated the principle of *functus officio*, which prevents a panel from reconsidering a final award; and (2) the panel's belief that its original award was not final because the arbitration was not bifurcated was erroneous. In recent weeks, two additional decisions have addressed these issues.

Finding Exception To Finality Rule, Second Circuit Rules That Arbitrators Retain Authority To Clarify Ambiguous Award

The Second Circuit recognized an exception to *functus officio*, ruling that when an arbitration award is ambiguous, the arbitrators retain authority to clarify that award. *General Re*

Life Corp. v. Lincoln National Life Ins. Co., 2018 WL 6186078 (2d Cir. Nov. 28, 2018).

The reinsurance dispute between General Re and Lincoln centered on whether General Re was entitled to increase the premiums on certain life insurance policies. An arbitration panel issued an award holding that the agreement between the parties allowed General Re to increase the premiums and also allowed Lincoln to recapture the policies rather than pay the increased premiums. The award stated that "[a]ll premium and claim transactions paid by one party to the other following the effective date of the recapture (*i.e.*, from April 1, 2014) shall be unwound." The parties took different positions as to how this language applied to premium payments made prior to April 1, 2014.

Lincoln petitioned the panel for guidance on the issue. General Re objected to the request, arguing that the panel would exceed its authority if it reconsidered or fundamentally changed the final award. Thereafter, the panel issued a "Clarification," stating that the final award was ambiguous and that both parties were reading it in a manner inconsistent with the parties' reinsurance agreement. The Clarification explained that General Re was entitled to retain all premiums paid prior to April 1, 2014, including unearned premiums, but that it remained liable for paying claims for all covered deaths, even those that occurred after April 1, 2014. A Connecticut federal district court granted Lincoln's petition to confirm the Clarification and denied General Re's petition to confirm the original award. The Second Circuit affirmed.

Under the doctrine of *functus officio*, once an arbitration panel has fully exercised its authority to adjudicate the issues submitted to it, its authority ceases and the panel has no further authority to reconsider those issues. However, the Second Circuit recognized an exception to *functus officio* where, as here, an award is susceptible to more than one interpretation or fails to address a contingency that later arises. The court emphasized the limited nature of the exception, stating that three conditions must be met to justify a clarification: (1) the final award is ambiguous; (2) the clarification clarifies the award rather than substantively modifies it; and (3) the clarification is consistent with the parties' underlying agreement.

Florida Court Rules That Panel's Liability Award Was Not Final Because Of Bifurcation Of Liability And Damages

A Florida federal district court ruled that a panel's arbitration award as to liability was not final, even though the parties agreed to bifurcate arbitration between liability and damages. *Lowell at Camelot, Inc. v. New Home Warranty Ins. Co.*, No. 18-cv-21155 (S.D. Fla. Nov. 28, 2018).

New Home Warranty provided structural defect warranty coverage for a home built by Lowell. When the home began to fall apart, the parties disputed whether New Home Warranty was obligated to cover the loss. The contract contained a clause that required arbitration by Construction Dispute Resolution Services ("CDRS"). CDRS procedures bifurcate arbitration into two phases: a first phase addressing whether damage is covered and a second phase establishing how damages are to be allocated. After phase 1 is complete, the parties can either settle the damages issue on their own or return to arbitration for phase 2.

With respect to the structural defect warranty claim, the panel issued an award in favor of Lowell at the conclusion of phase 1. Lowell petitioned the court to confirm the award, and New Home Warranty moved to dismiss based on lack of subject matter jurisdiction, arguing that it was interim, not final. The court agreed and dismissed the suit. The court acknowledged that "the text of the arbitration award may suggest finality," but reasoned that the award was not final because the unresolved damages issue was related directly to the phase 1 "merits questions." The court further explained that because the arbitration agreement encompassed both liability and damages, it was reasonable to infer that the

parties meant to resolve both issues in a single proceeding. Finally, as to the bifurcated nature of the arbitration, rather than finding it indicative of finality, the court stated "that the parties arbitrated under a bifurcated proceeding in and of itself demonstrates the lack of finality in this process because it assumes a second arbitration."

California Court Refuses To Compel Consolidated Arbitration, Ruling That Consolidation Is Issue For Panel To Decide

A California federal district court granted a reinsurer's motion to compel appointment of an arbitrator and denied an insurer's cross-motion to compel consolidated arbitration, ruling that the question of whether multiple disputes should be consolidated should be decided by an arbitration panel. *Employers Ins. Co. of Wausau v. The Hartford*, 2018 WL 6330425 (C.D. Cal. Dec. 3, 2018).

Hartford billed Wausau under nineteen reinsurance treaties that Hartford and several of its affiliates had purchased from Wausau. When Wausau refused to pay, Hartford and its affiliates collectively demanded arbitration. In its demand, Hartford requested that Wausau name one arbitrator to serve on a single panel for a consolidated arbitration. In response, Wausau argued that three arbitrations needed to take place (one for each Hartford entity) and appointed three party arbitrators. Wausau argued that a single consolidated arbitration was not warranted because Hartford's demand involved multiple contracts, each with its own arbitration provision. Wausau moved to compel arbitration of one particular contract ("Treaty 2718"), seeking an order directing Hartford to proceed with the umpire selection process set forth in the arbitration clause of that contract. Hartford cross-moved for an order directing Wausau to select one arbitrator to participate in a single consolidated arbitration.

The court granted Wausau's motion to compel, noting that it was bound to enforce the operative arbitration agreement in Treaty 2718, which does not contemplate consolidation. The court directed the two party-appointed arbitrators to select an umpire pursuant to the procedures set forth in the arbitration provision in Treaty 2718. The court further held that once a panel was in place, it would have authority to decide the issue of consolidation, noting that a majority of courts have ruled that such questions are arbitration panel decisions.

In denying Hartford's cross-petition for consolidation, the court rejected Hartford's assertion that all of the companies collectively demanding arbitration were acting as a single party for the purpose of seeking reimbursement from Wausau for the same underlying settlement payment. The court explained that each Hartford affiliate was a distinct entity and that the arbitration provisions in various treaties differed as to umpire selection process and venue. The court stated: "the Court cannot compel Wausau to form a single arbitration panel based on the fact that the parties demanding arbitration are all Hartford affiliates. . . . Harford's cross-motion to compel is a de facto request for the Court to fashion a new procedure in contravention of the terms of the agreements."

Breach Of Contract Alert:

Second Circuit Dismisses Policyholder's Breach Of Contract Claims Against Insurer Based On Insurer's Settlement

The Second Circuit affirmed a decision dismissing breach of contract and bad faith claims against an insurer, finding that the insurer's decision to settle claims asserted against it did not violate any contractual duties that the insurer owed to its policyholder. *Keller Foundations, LLC v. Zurich American Ins. Co.*, 2018 WL 6431537 (2d Cir. Dec. 6, 2018).

Zurich insured Keller Foundations under a general liability policy. Diaz, a general

contractor, sued Zurich, arguing that it was an additional insured under the policy. The parties settled that suit with a payment of $450,000 from Zurich to Diaz. Thereafter, Zurich obtained reimbursement for the settlement from Capital Insurance pursuant to a reinsurance agreement. After Capital paid Zurich, Capital then sought reimbursement from Keller because Capital is owned and fully funded by Keller.

After Keller reimbursed Capital, Keller sued Zurich alleging breach of contract and the duty of good faith and fair dealing. Keller argued that Zurich breached its duties under the liability policy by settling the suit with Diaz and then seeking reimbursement from Capital. Keller argued that Zurich had a duty not to "use Policy funds to defend and settle a claim that sought to impose liability on Zurich itself." A New York district court rejected this argument and granted Zurich's motion to dismiss. The Second Circuit affirmed.

The Second Circuit held that Keller failed to allege breach of contract because the insurance policy did not bar Zurich from settling claims against it, and even assuming it did, Keller failed to allege any damages flowing from that settlement. The court rejected Keller's assertion that it was damaged because it was obligated to reimburse Capital for a portion of the settlement and to pay a deductible under the reinsurance agreement.

Construction Defect Alert:

Two Connecticut Courts Find No Coverage For Cracking Concrete Claims

Our October 2018 Alert discussed a Second Circuit decision holding that a property insurer had no duty to cover losses arising from the cracking and deterioration of concrete walls in the policyholders' residence. *See Kim v. State Farm Fire & Cas. Ins. Co.*, 2018 WL 4847195 (2d Cir. Oct. 5, 2018). Dozens of other cases involving this issue are currently pending in Connecticut courts. In recent weeks, two Connecticut federal district courts held that a property insurer has no obligation to pay for losses related to the cracking and deterioration of concrete foundations because such damage did not constitute a covered "collapse."

In *Cockill v. Nationwide Property & Cas. Ins. Co.*, 2018 WL 6182422 (D. Conn. Nov. 27, 2018), homeowners sought coverage for cracking in the concrete foundation of their home. An inspector concluded that the concrete was undergoing a chemical reaction and would have to be replaced. Nationwide denied coverage. The court agreed with the insurer that the claims did not allege a "collapse," defined as the "abrupt falling down or caving in" of a structure "with the result that it cannot be occupied for its intended purpose." The court emphasized policy language stating that a structure is not in a state of collapse if it is still standing, even if it is "in danger of falling down or caving in" or "shows signs of . . . cracking." Based on this unambiguous language, the court concluded that the homeowners' allegations of substantial impairment of structural integrity did not trigger coverage under the collapse provision. In so ruling, the court noted that even if the concrete walls were deteriorating and essentially caving in, the damage would be gradual, not "abrupt" as required by the policy.

Additionally, the court rejected the homeowners' assertion that losses due to a chemical reaction are not excluded from coverage. Although "chemical reactions" was not specifically listed among the enumerated exclusions, the court found that other listed exclusions (*e.g.*, wear and tear, deterioration and inherent vice), were broad enough to encompass chemical reactions. In any event, the court held that the only observed manifestation of the chemical reaction was the foundation cracking, which was excluded under the collapse provision.

Finally, the court dismissed the homeowners' claim for reimbursement of "reasonable

costs you incur for necessary repairs made solely to protect covered property from further damage," noting that this provision applies only "if the peril causing the loss is covered." Here, because the cracking concrete fell outside the scope of coverage, the court deemed the reasonable repairs provision inapplicable.

In *Hyde v. Allstate Ins. Co.*, 2018 WL 6331799 (D. Conn. Dec. 4, 2018), the court reached the same conclusion, ruling that concrete cracking, decay and oxidization in basement walls was not a covered loss under a homeowners' policy. The court held that the gradual deterioration of the concrete walls was not "sudden and accidental direct physical loss," as required by the policy. Further, the court found no coverage under a collapse provision, which similarly required the collapse to be "sudden." The court explained that "sudden" is unambiguous and requires "temporal abruptness." The homeowners' claims failed to allege this requirement because they asserted that the decay process occurred "over the course of years" – notwithstanding allegations that the decay would ultimately result in "complete degradation" and/or "sudden events throughout the course of decay," such as shifting, bulging or cracking.

In other defective concrete news, this month the Connecticut Supreme Court is scheduled to hear arguments in *Karas v. Liberty Ins. Corp.*, 2018 WL 2002480 (D. Conn. Apr. 30, 2018) (discussed in our May 2018 Alert). There, the court will address the following certified question: "what constitutes 'substantial impairment of structural integrity' for purposes of applying the 'collapse' provision of this homeowners' insurance policy?" We will keep you posted on any developments in this matter.

Excess Alert:

California Court Rules That Primary Insurer's Settlement Does Not Bind Excess Insurer To Cover Uninsurable Loss

A California federal district court ruled that a second-tier excess carrier was not obligated to cover uninsurable disgorgement payments notwithstanding that a primary and first layer carrier had settled those claims up to their policy limits. *AXIS Reinsurance Co. v. Northrop Grumman Corp.*, No. 2:17-CV-8660 (C.D. Cal. Nov. 21, 2018).

Northrop was insured under a primary policy issued by National Union, a first layer excess policy issued by Continental Casualty and a second layer policy issued by AXIS. Northrop sought coverage from the insurers for a settlement with the Department of Labor relating to certain alleged wrongful activity. National Union and Continental Casualty paid amounts equal to the remaining limits of their policies. AXIS made some payment, but filed suit seeking reimbursement on the basis that its policy was "unnecessarily triggered as a result of improper erosion."

The court granted AXIS's summary judgment motion, finding that the underlying settlement was an uninsurable loss. The court reasoned that the settlement consisted of uninsurable disgorgement payments because the Department of Labor specifically instructed Northrop to restore all payments or reimbursements made in violation of ERISA. Although "disgorgement" was not used in the settlement, the court concluded that it was clear from the investigation and settlement that Northrop was returning ill-gotten gains. Further, the court ruled that AXIS was not obligated to provide coverage as a result of the lower level insurers' decision to pay for the settlement and the exhaustion of their policies. The court explained that AXIS was not bound by the independent decisions of the underlying insurers when its own policy did not provide coverage. The court distinguished cases in which courts have prohibited excess insurers from challenging a primary carrier's payment decisions on the basis that those cases involved losses that were within the scope of coverage under the excess policy.

Class Action Alert:

Eighth Circuit Affirms Certification Of Class Action Against State Farm Based On Labor Depreciation

The Eighth Circuit affirmed an Arkansas district court decision certifying a class of homeowners who allege that State Farm improperly withheld amounts for labor depreciation when making claim payments. *Stuart v. State Farm Fire & Casualty Co.*, 2018 WL 6358447 (8th Cir. Dec. 6, 2018).

The class consists of State Farm policyholders who allege that State Farm improperly depreciated the costs of labor when calculating "actual cash value" ("ACV") payments under their policies. The district court concluded that the plaintiffs demonstrated that "questions of law or fact common to class members predominate over any questions affecting any individual members," as required by Federal Rule of Civil Procedure 23(b)(3). Affirming the ruling, the Eighth Circuit found that plaintiffs' claims shared a common, predominating question of law – namely, whether State Farm breached its contracts by depreciating labor costs when calculating claim payments. The Eighth Circuit rejected State Farm's assertion that individual issues of liability and damages exist for each plaintiff that cannot be established with common evidence. Distinguishing cases in which commonality was not found because of case-by-case differences in calculating claim values, the court emphasized that here, the policies specified the method for calculating actual cash value payments.

The Eighth Circuit also rejected State Farm's contention that class certification was inappropriate because certain plaintiffs lacked standing. State Farm argued that plaintiffs who completed repairs at or below the cost of the ACV payment did not suffer injury and thus lacked standing. The court disagreed, finding that any individual that received an improperly-depreciated ACV payment suffered a legal injury "regardless of whether the ACV payment was more than, less than, or exactly the same as the ultimate cost of repairing or replacing their property."

Simpson Thacher News Alert

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Simpson Thacher sends warm season's greetings and best wishes for a wonderful new year.

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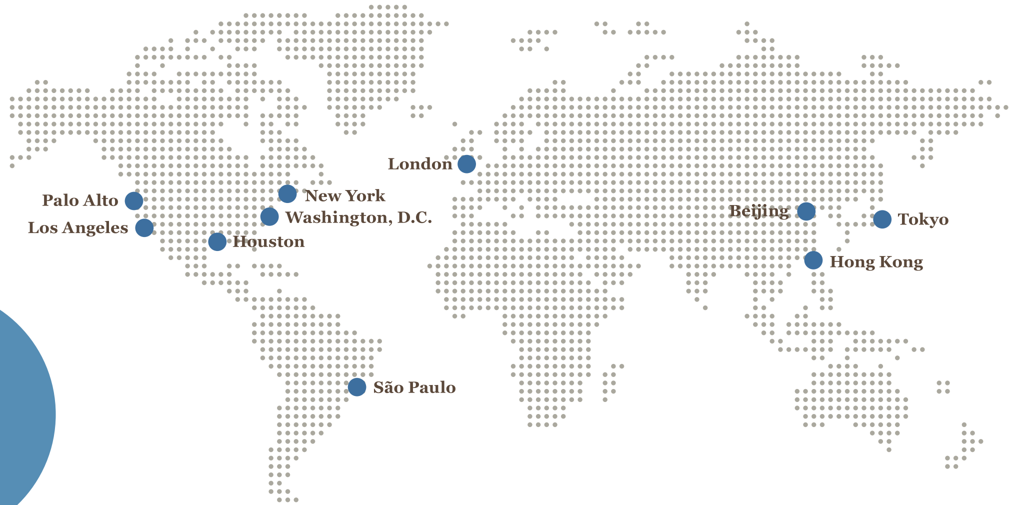

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