Simpson Thacher

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The Supreme Judicial Court of Massachusetts ruled that inclusion of a consent-to-settle clause in a professional liability policy does not violate state statutory law requiring insurers to engage in good faith settlement negotiations. *Rawan v. Cont'l Cas. Co.*, 136 N.E.3d 327 (Mass. 2019). (Click here for full article)

Computer Fraud Provision Covers Loss Caused By Email Phishing Scam, Says Virginia Court

A Virginia federal district court ruled that losses caused by an email phishing scam are covered by a computer fraud provision because the losses resulted "directly" from the use of a computer. *Cincinnati Ins. Co. v. Norfolk Truck Ctr., Inc.*, 2019 WL 6977408 (E.D. Va. Dec. 20, 2019). (Click here for full article)

Company's Loss Of Data, Caused By Ransomware Attack, Is "Direct Physical Loss" Of Property Under Business Policy

A Maryland federal district court ruled that the loss of data and impairment of a computer system resulting from a ransomware attack constituted "direct physical loss" under a businessowner's policy. *Nat'l Ink & Stitch, LLC v. State Auto Prop. & Cas. Ins. Co.*, 2020 WL 374460 (D. Md. Jan. 23, 2020). (Click here for full article)

South Carolina Court Of Appeals Rules That Successor Company Is Not Entitled To Coverage Under Predecessor's Policies

The South Carolina Court of Appeals ruled that a successor company was not entitled to insurance coverage under policies issued to its predecessor company because the insurer had not consented to the assignment of policy benefits. *PCS Nitrogen, Inc. v. Cont'l Cas. Co.*, 2019 WL 6884913 (S.C. Ct. App. Dec. 18, 2019). (Click here for full article)

"[Simpson Thacher] is one of the preeminent and most sophisticated coverage litigation firms."

– *Chambers USA* 2019 (quoting a client)

New York Bankruptcy Court Rules That Fee Exclusions Do Not Bar Coverage For Class Action Suits Alleging Improper Mortgage Fees

A New York bankruptcy court ruled that neither a Return of Fees Exclusion nor a Mortgage Fee Claim Exclusion barred coverage for class action suits alleging improper origination and closing fees charged in connection with second mortgages. *In re Residential Capital*, 2019 WL 7286880 (Bankr. S.D.N.Y. Dec. 27, 2019). (Click here for full article)

Ohio Appellate Court Rules That Umbrella Policy Covers Loss Caused By Incorporation Of Defective Component Into Final Product

An Ohio appellate court ruled that an umbrella insurer was obligated to defend and indemnify claims arising out of the incorporation of a defective component into glass bottles. *Motorists Mut. Ins. Co. v. Ironics, Inc.*, 2020 WL 261696 (Ohio. Ct. App. Jan. 17, 2020). (Click here for full article)

Fifth Circuit Rules That Rock Fines Released Into Stream Are Contaminants, Even Though Not Inherently Hazardous

The Fifth Circuit ruled that coverage for damage caused by the release of small rock particles into a nearby water source was barred by a pollution exclusion because the particles acted as a contaminant once discharged into the water. *E. Concrete Materials, Inc. v. Ace Am. Ins. Co.*, 2020 WL 254822 (5th Cir. Jan. 17, 2020). (Click here for full article)

STB News Alert

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Settlement Alert:

Massachusetts Supreme Judicial Court Rules That Consent-To-Settle Clause Does Not Violate Insurer's Statutory Good Faith Settlement Obligations

The Supreme Judicial Court of Massachusetts ruled that inclusion of a consent-to-settle clause in a professional liability policy does not violate state statutory law requiring insurers to engage in good faith settlement negotiations. *Rawan v. Cont'l Cas. Co.*, 136 N.E.3d 327 (Mass. 2019).

Continental issued a professional liability policy to Lala, a structural engineer. The policy included a consent-to-settle clause, which provided that Continental would not settle any claim without Lala's consent. The policy did not contain a "hammer clause" stating that Continental's liability would be limited if Lala refused to settle. After Lala was sued by homeowners, Continental agreed to defend, conducted an investigation, and encouraged Lala to settle. Lala refused, and the case went to trial, resulting in a judgment in the homeowners' favor. Continental paid the homeowners the remaining policy limits after payment of defense costs, and Lala paid the balance.

The homeowners sued Continental, alleging that it had violated statutory law by failing to effectuate a prompt and equitable settlement of their claims. The court addressed whether a consent-to-settle clause in a professional liability policy inherently conflicts with an insurer's statutory obligation to effectuate a prompt settlement once liability has been clearly established. The court held that such clauses do not violate statutory law. In reaching this conclusion, the court acknowledged potential tension between a consent-to-settle provision and insurers' statutory settlement obligation, but found no legislative intent to prohibit such clauses. Additionally, the court explained that it would be inappropriate to impute Lala's refusal to settle to Continental for purposes of finding a statutory violation given that Continental's ability to settle was contingent upon Lala's consent. The court therefore held that an insurer's statutory duty to effectuate a prompt, fair settlement does not require the insurer to violate a consent-to-settle clause, even where liability has been clearly established.

However, the court cautioned that an insurer who honors a consent-to-settle clause is not necessarily exonerated from statutory settlement duties. Rather, the determination of whether an insurer has complied with its dual obligations is fact specific. The court concluded that Continental satisfied its statutory obligations by conducting a thorough investigation and value assessment of the claim against Lala and by engaging in good faith efforts to convince Lala to settle.

Addressing a separate issue, the court held that although certain pre-verdict conduct on the part of the insurer was potentially "problematic," it did not harm the homeowners. More specifically, the court found that Continental's decision not to share an engineering report with the homeowners and a misstatement regarding policy limits (whether intentional or accidental) did not result in any harm to the homeowners; rather, Lala's refusal to settle was the proximate cause of plaintiffs' harm.

Cyber Coverage Alerts:

Computer Fraud Provision Covers Loss Caused By Email Phishing Scam, Says Virginia Court

A Virginia federal district court ruled that losses caused by an email phishing scam are covered by a computer fraud provision because the losses resulted "directly" from the use of a computer. *Cincinnati Ins. Co. v. Norfolk Truck Ctr., Inc.*, 2019 WL 6977408 (E.D. Va. Dec. 20, 2019).

Norfolk Truck Center ordered truck parts from Kimble Mixer Company. Following the order, Norfolk received an email from an imposter claiming to be a Kimble employee that provided payment instructions for the purchase. Norfolk completed the necessary paperwork with its bank and issued a wire transfer in the amount of $333,724 in accordance with the imposter's instructions. When Norfolk discovered that the email with the instructions was fraudulent, it sought coverage under a computer fraud provision,

which covered loss "resulting directly from the use of any computer to fraudulently cause a transfer of [money]." The insurer denied coverage, arguing that the loss did not result "directly" from computer use.

Addressing this matter of first impression under Virginia law, the court ruled that the term "directly," as used in the computer fraud provision, is unambiguous and means "straightforward" or "proximate" and "without intervening agency." Applying this interpretation, the court concluded that the wire transfer loss resulted directly from computer use. The court explained that "[c]omputers were used in every step of the way including receipt of the fraudulent instructions and the insured's compliance with such instructions by directing its bank to wire the funds to the fake payee."

The court rejected the insurer's contention that the loss was not direct because multiple individuals were involved in the wire transfer over the course of six days. The court also found unpersuasive the insurer's assertion that coverage was unavailable because Norfolk was attempting to pay a legitimate invoice, rather than a fraudulent bill. The court stated: "[t]he instant insurance provision does not require a fraudulent payment by computer; rather it requires a computer's use to fraudulently cause a transfer of money."

As discussed in last month's Alert, the Eleventh Circuit similarly held that a fraudulently-induced wire transfer initiated by an email phishing scheme satisfied the "directly" requirement of a computer fraud provision.

Company's Loss Of Data, Caused By Ransomware Attack, Is "Direct Physical Loss" Of Property Under Business Policy

A Maryland federal district court ruled that the loss of data and impairment of a computer system resulting from a ransomware attack constituted "direct physical loss" under a businessowner's policy. *Nat'l Ink & Stitch, LLC v. State Auto Prop. & Cas. Ins. Co.*, 2020 WL 374460 (D. Md. Jan. 23, 2020).

National Ink, an embroidery and screen printing business, was the victim of a ransomware attack that prevented the company from accessing its art files, server data and software programs. National Ink hired a security company to replace and reinstall its software, along with new protective measures, on its computer system. Thereafter, although the computers still functioned, computer processing was slower, resulting in a loss of efficiency. In addition, art files could not be retrieved. The security company opined that remnants of the virus could potentially re-infect the system and that purchasing an entirely new system would eliminate that risk.

National Ink filed a claim with State Farm for replacement of the entire computer system. State Farm denied coverage, arguing that there was no "direct physical loss or damage," as required by the policy. More specifically, State Farm claimed that because National Ink only lost data, an intangible asset, and could still use its computer system, there was no physical loss. The court disagreed and granted National Ink's summary judgment motion.

The policy covers "direct physical loss of or damage to Covered Property," which is defined to include "Electronic Media and Records (Including Software)." Electronic Media and Records, in turn, is defined to specifically include: "(a) Electronic data processing, recording, or storage media such as films, tapes, discs, drums or cells; [and] (b) Data stored on such media." The court concluded that this language squarely placed National Ink's loss of data and software within the scope of coverage. In addition, the court ruled that the loss of efficiency to and reliability of the computer system constituted covered damage, notwithstanding that the computer was still operable. Rejecting State Farm's assertion that physical loss requires an "utter inability to function," the court stated that "[t]he policy language, and the relevant case law, impose no such prerequisite."

Assignment Alert:

South Carolina Court Of Appeals Rules That Successor Company Is Not Entitled To Coverage Under Predecessor's Policies

The South Carolina Court of Appeals ruled that a successor company was not entitled to insurance coverage under policies issued to its predecessor company because the insurer had not consented to the assignment of policy benefits. *PCS Nitrogen, Inc. v. Cont'l Cas. Co.*, 2019 WL 6884913 (S.C. Ct. App. Dec. 18, 2019).

From 1966 to 1972, Columbia Nitrogen Corporation ("Old CNC") operated fertilizer plants in Charleston. During that time frame, Old CNC was insured under policies issued by Continental. In 1986, Old CNC entered into an acquisition agreement, which sold most of its assets to CNC Corp. ("New CNC"). In addition to the assets, New CNC assumed some of Old CNC's liabilities related to the "acquired business." The agreement also included a document titled "Assignment of Insurance Benefits," which stated that Old CNC "has agreed to sell, convey, transfer, and assign . . . all of [its] rights, proceeds and other benefits to and under all of [its] policies." New CNC later changed its name and entered into merger agreements with several other companies, ultimately becoming part of PCS Nitrogen. In 2013, PCS Nitrogen was found liable for environmental remediation as a corporate successor to Old CNC. PCS Nitrogen sought coverage under Old CNC's policies, which Continental denied. A South Carolina trial court granted the insurer's summary judgment motion, and the appellate court affirmed.

The appellate court ruled that the policies were not assigned to New CNC because Old CNC did not obtain the consent from the insurers required by the policies and South Carolina law. The court further held that the assignment was invalid as a post-loss assignment because there were no vested claims from prior actions against Old CNC at the time of assignment. The policies specified that coverage was not available "until the amount of the insured's obligation to pay shall have been finally determined by judgment . . . or by written agreement." Under this language, and because no actions had been filed against Old CNC prior to the asset sale, the court held that no losses had occurred and no vested claims existed. The court explained that although the operative occurrences (*i.e.*, contamination) may have occurred during the policy period, the insured loss (*i.e.*, the insured's obligation to pay a sum of money) did not occur prior to the assignment.

Coverage Alerts:

New York Bankruptcy Court Rules That Fee Exclusions Do Not Bar Coverage For Class Action Suits Alleging Improper Mortgage Fees

A New York bankruptcy court ruled that neither a Return of Fees Exclusion nor a Mortgage Fee Claim Exclusion barred coverage for class action suits alleging improper origination and closing fees charged in connection with second mortgages. *In re Residential Capital*, 2019 WL 7286880 (Bankr. S.D.N.Y. Dec. 27, 2019).

Class action plaintiffs paid origination or closing fees in connection with second mortgages or subordinate loans. Those fees were paid to the originating banks and other third parties, but not to Residential Capital Corporation, a financial services company that purchased and packaged mortgage loans for sale to investors. Residential Capital did not originate or close any of the loans at issue and did not have any contact with the class plaintiffs prior to its purchase of the loans. In the class action suits, plaintiffs alleged that Residential Capital was derivatively liable for the acts of the originating banks and directly liable based on its conduct after purchasing the loans.

Residential Capital filed for bankruptcy and then settled the class action suits. In connection with the settlements, the class plaintiffs were assigned Residential Capital's rights under its insurance policies. In the present suit, the class plaintiffs sought coverage for their settlements under combined Directors and Officers/Errors and Omissions policies. The insurers denied coverage on the basis of two exclusions. The court granted the plaintiffs' summary judgment motion, holding that coverage was not barred by the Return of Fees Exclusion or Mortgage Fee Claim Exclusion.

The Return of Fees Exclusion bars coverage for "premiums, return premiums, fees, commissions, costs, expenses or other charges paid or payable by or to the Assured." The court held that the exclusion, which expressly requires payment "to the Assured," was inapplicable because the fees were paid to the originating banks and others, and not directly to Residential Capital. The court also rejected the insurers' contention that a Deemer clause, which states that an Assured is "any person or entity for whose conduct an Assured is legally responsible," renders the Exclusion applicable to any claims that are based on fees paid to entities for whom Residential Capital was legally responsible, such as the originating banks. The court reasoned: "Even if the definition of the word 'Assured' were expanded by the Deemer Clause, the Plaintiffs' claims relating to [Residential Capital] are not covered by the exclusion because [Residential Capital] was not 'the' Assured that engaged in the excluded conduct." The court emphasized the difference between language referencing "the" Assured and "any" or "an" Assured, implying that only the latter would encompass Residential Capital.

The court also ruled that a Mortgage Fee Claim Exclusion was inapplicable. That exclusion defined Mortgage Fee Claim as "a Claim arising out of fees paid to or by a Professional Liability Assured." Although the parties agreed that Residential Capital was a Professional Liability Assured, the court deemed it determinative that no fees were paid by or to Residential Capital.

Ohio Appellate Court Rules That Umbrella Policy Covers Loss Caused By Incorporation Of Defective Component Into Final Product

An Ohio appellate court ruled that an umbrella insurer was obligated to defend and indemnify claims arising out of the incorporation of a defective component into glass bottles. *Motorists Mut. Ins. Co. v. Ironics, Inc.*, 2020 WL 261696 (Ohio. Ct. App. Jan. 17, 2020).

Ironics sold tube scale to Owens-Brockway for use in the production of glass bottles. Unbeknownst to Ironics, foreign particles were inadvertently mixed into the tube scale, a defect that was not discovered until Owens-Brockway had incorporated the tube scale into its glass bottles. Because the damage was irreversible, Owens-Brockway was required to scrap nearly 2,000 tons of bottles. When Owens-Brockway sued, Ironics sought defense and indemnity from Motorists under a general liability policy and an umbrella policy. The trial court ruled that there was no coverage under either policy. The appellate court reversed in part.

With respect to the general liability policy, the appellate court assumed, without deciding, that Ironics' delivery of non-conforming tube scale constituted an "occurrence" that caused "property damage." However, the court concluded that coverage was barred by a contractual liability exclusion. The court rejected Ironics' assertion that the exclusion did not encompass underlying negligence and product liability claims. The court explained that those tort claims were not cognizable under Ohio's economic-loss rule, which prevents recovery of damages for purely economic loss.

However, the appellate court ruled that Motorists was obligated to defend and indemnify Ironics under the umbrella policy. Emphasizing that the umbrella policy defines "occurrence" broadly to include "an accident, or a happening or event" resulting in property damage, the court concluded that Ironics' supply of defective tube scale was an "event."

As to whether the event resulted in "property damage" under the umbrella policy, Motorists argued that there must be damage to "other property" (aside from the insured's own defective tube scale) in order to trigger coverage. Furthermore, Motorists argued that the glass bottles could not be considered such "other property" because, under applicable case law, once an insured's defective component is irreversibly integrated into a product, the final product cannot be deemed "damage to other property" for the purposes of insurance coverage. The court rejected these assertions.

First, the court ruled that the umbrella policy does not require damage to other property because it defines "property damage" to include "physical injury to or destruction of tangible property . . . including all resulting loss of use of that property," without any reference to "other property." In addition,

the court ruled that there was damage to other property (*i.e.*, the glass bottles) and that case law relating to integrated products was inapplicable. The court stated:

> Unlike the limited scope of coverage applicable to CGL policies, the umbrella policy in this case is, by its very terms, designed to provide broad coverage for claims that are not otherwise covered by Ironics' CGL policy . . . Given the differences between a CGL policy and an umbrella policy, it would be inappropriate to impose the [ ] integrated system rule here, especially where the rule itself is not contained in the policy language.

Finally, the court rejected Motorists' contention that a "your product" exclusion, among others, precluded coverage. The court held that the glass bottles could not be deemed Ironics' product, reiterating that "integrated product" case law was inapplicable in the context of the umbrella policy.

Pollution Exclusion Alert:

Fifth Circuit Rules That Rock Fines Released Into Stream Are Contaminants, Even Though Not Inherently Hazardous

The Fifth Circuit ruled that coverage for damage caused by the release of small rock particles into a nearby water source was barred by a pollution exclusion because the particles acted as a contaminant once discharged into the water. *E. Concrete Materials, Inc. v. Ace Am. Ins. Co.*, 2020 WL 254822 (5th Cir. Jan. 17, 2020).

The underlying claims arose out of the dispersal of rock fines (small rock particles resulting from the stone-crushing process at the insured's quarry) into an adjacent reservoir. The rock fines were supposed to be contained in settling ponds, but due to a pumping accident, were carried into a waterway that led to a reservoir. According to government agencies, the rock fines damaged the stream bed and required remediation. The insurers denied coverage to the quarry based on a pollution exclusion.

A Texas federal district court enforced the exclusion, ruling that the rock fines were pollutants notwithstanding their "ordinary usefulness." Rejecting the quarry's assertion that rock fines are a nonhazardous material, the district court stated: "If they were indeed innocuous, the State of New Jersey would not have required remediation." *See* July/August 2018 Alert.

The Fifth Circuit affirmed, ruling that the rock fines were "contaminants" because they were "discharged and dispersed where they did not belong." The court rejected the insured's contention that this interpretation was "dangerously overbroad because it allows anything (even water or bricks) to become contaminants if left in an inappropriate place." The court explained that the rock fines must be deemed contaminants based on their effects on the overall ecosystem, including harm to habitat, fish and other species.

STB News Alert:

Lynn Neuner was honored as a "Notable Woman in Law" for 2020 by *Crain's New York*. This annual feature celebrates trailblazing female attorneys in the New York City metropolitan area. Lynn was recognized for her work advising on complex and high-profile matters, as well as her leadership positions within and outside the Firm.

Simpson Thacher

Simpson Thacher has been an international leader in the practice of insurance and reinsurance law for more than a quarter of a century. Our insurance litigation team practices worldwide.

Mary Beth Forshaw
+1-212-455-2846
mforshaw@stblaw.com

Andrew T. Frankel
+1-212-455-3073
afrankel@stblaw.com

Lynn K. Neuner
+1-212-455-2696
lneuner@stblaw.com

Chet A. Kronenberg
+1-310-407-7557
ckronenberg@stblaw.com

Bryce L. Friedman
+1-212-455-2235
bfriedman@stblaw.com

Michael J. Garvey
+1-212-455-7358
mgarvey@stblaw.com

Tyler B. Robinson
+44-(0)20-7275-6118
trobinson@stblaw.com

George S. Wang
+1-212-455-2228
gwang@stblaw.com

Craig S. Waldman
+1-212-455-2881
cwaldman@stblaw.com

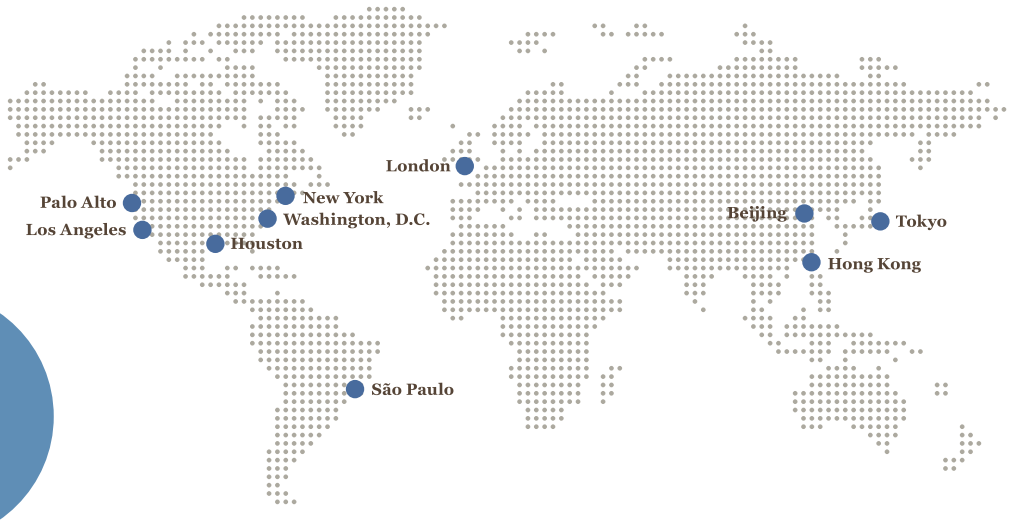
Susannah S. Geltman
+1-212-455-2762
sgeltman@stblaw.com

Elisa Alcabes
+1-212-455-3133
ealcabes@stblaw.com

Summer Craig
+1-212-455-3881
scraig@stblaw.com

Jonathan T. Menitove
+1-212-455-2693
jonathan.menitove@stblaw.com

This edition of the Insurance Law Alert was prepared by Mary Beth Forshaw mforshaw@stblaw.com /+1-212-455-2846 and Bryce L. Friedman bfriedman@stblaw.com /+1-212-455-2235 with contributions by Karen Cestari kcestari@stblaw.com.



Simpson Thacher Worldwide

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
600 Travis Street, Suite 5400
Houston, TX 77002
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
900 G Street, NW
Washington, D.C. 20001
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3901 China World Tower A
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000