Simpson Thacher

Insurance Law Alert

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A Washington appellate court ruled that a property insurer acted in bad faith in refusing to defend a lawsuit alleging that the homeowners shot guns onto neighboring property, finding that the alleged conduct constituted a covered occurrence. *Webb v. USAA Casualty Ins. Co.*, 2020 WL 812137 (Wash. Ct. App. Feb. 19, 2020). (Click here for full article)

Coronavirus Alert: Has There Been "Physical Damage" By A Covered Peril?

Click here to read more about the scope of business interruption coverage for coronavirus-related losses.

Reinsurance Alert:

New York Court Addresses Whether Facultative Reinsurance Contracts Cap Both Indemnity Payments And Expenses, Eroding *Bellefonte* Rule

Following a lengthy history including review and rulings by the Second Circuit and New York Court of Appeals (*see* December 2016 and 2017 Alerts), a New York federal district court ruled that facultative reinsurance contracts unambiguously cap both indemnity and expense payments when there are no losses but do not cap expense payments when there are losses. *Global Reinsurance Corp. of Am. v. Century Indem. Co.*, 13 Civ. 6577 (S.D.N.Y. Mar. 2, 2020).

The dispute between Century and Global Reinsurance concerned the extent of Global Reinsurance's obligations under certain facultative reinsurance contracts issued to Century. In 2014, a New York federal district court ruled that the certificates unambiguously capped Global Reinsurance's liability at $250,000 (the amount set forth in the Reinsurance Accepted provision) for both losses and expenses. In so ruling, the district court relied on *Bellefonte Reinsurance Co. v. Aetna Casualty & Surety Co.*, 903 F.2d 910 (2d Cir. 1990) and *Unigard Security Insurance Co. v. North River Insurance Co.*, 4 F.3d 1049 (2d Cir. 1993), noting that the relevant language in the certificates at issue was nearly identical to that presented in *Bellefonte*.

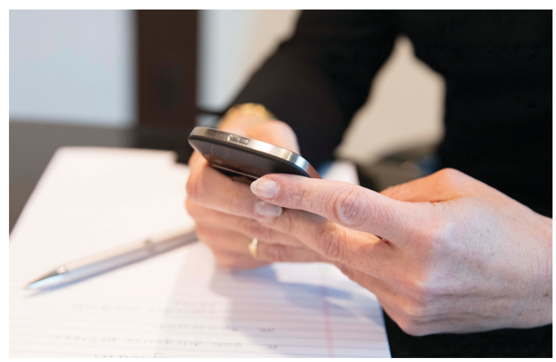
On appeal, the Second Circuit "cast doubt on the continued force of *Bellefonte* and *Unigard*," and, by certification, asked the New York Court of Appeals to decide whether New York precedent:

> impose[s] either a rule of construction, or a strong presumption, that a per occurrence liability cap in a reinsurance contract limits the total reinsurance available under the contract to the amount of the cap regardless of whether the underlying policy is understood to cover expenses, such as, for instance, defense costs.

The Court of Appeals answered the question in the negative, emphasizing that "the standard rules of contract interpretation apply" and that policy language must be interpreted on a case-by-case basis. Thereafter, the Second Circuit remanded the matter with directions to the district court to "construe each reinsurance policy solely in light of its language, and to the extent helpful, specific context."

Upon remand and following an evidentiary hearing, the district court ruled that "the plain and unambiguous meaning of the reinsurance contracts is that the dollar amount stated on the facultative certificates caps indemnity payments and also caps expense payments when there are no losses, but does not cap expense payments when there are losses."

The court relied on several contractual provisions in the certificates, including a Following Form clause, which stated that Global's liability is "subject in all respects to all the terms and conditions of the Company's policy." The court deemed this provision "highly relevant" because under Century's policies, the insurer must pay expenses in addition to limits of liability.



The court also cited a Payments Provision, which outlined Global's payment obligations upon Century's submission of a claim. The court concluded that a sentence in this provision carved out an exception to the "follow form" requirement for cases in which "there is no loss payment" because that sentence referenced the dollar amount that limits indemnity payments. The court therefore concluded that for instances in which no loss is paid, Global's total liability for both indemnity and expenses is capped at the reinsurance limit. However, where loss payments are made, the court ruled that expense payments are not subject to a cap because a different sentence, which referred to loss payment scenarios, "does not limit the expense costs that Global owes by reference to a limit or dollar amount stated in the certificate." Thus, the court ruled that for instances in which Global makes a loss payment, the certificates must "follow" the underlying insurance as to the payment of expenses in addition to indemnity.

The court rejected Global's argument that the certificates' Preamble, which stated that reinsurance is "subject to the terms, conditions and limits of liability set forth herein," establishes an overall liability limit. The court stated: "This prefatory language is insufficiently detailed or explicit to override the Payments Provision's specific directives as to expenses when there are loss payments and when there are no loss payments." Finally, the court noted that its textual interpretation was confirmed by expert testimony regarding relevant industry custom and practice.

Coverage Alerts:

Ninth Circuit Deems "Claims First Made" Provision Ambiguous As To Whether Factually-Related Claims Can Be Considered A Single Claim

The Ninth Circuit ruled that a "claims first made" provision in a liability policy was ambiguous as to whether a pre-policy demand letter and an action filed during the policy period could be considered a single claim "first made" prior to policy inception. *National Union Fire Ins. Co. v. Zillow, Inc.*, 2020 WL 774366 (9th Cir. Feb. 18, 2020).

The policy at issue provided coverage "solely with respect to Claims first made against an Insured during the Policy Period . . . and reported to the Insurer." A Washington district court ruled that the policy did not cover a copyright infringement suit brought against Zillow by VHT, Inc. during the policy period. The court reasoned that the VHT action was based on the same wrongful conduct as that alleged by VHT in a demand letter sent to Zillow prior to the policy's inception, and that the demand letter and action comprised a single claim that was "first made" before the policy period.

The Ninth Circuit reversed, ruling that policy language did not explicitly allow or require factually-related claims to be considered a single claim for purposes of the "claims first made" provision. In so ruling, the court noted that "unlike a number of other claims-first-made policies cited by both parties, the Policy does not contain a provision expressly providing for the integration of factually related Claims." The court deemed the policy ambiguous as to whether the pre-policy demand letter and subsequent action could be considered a single claim. The court remanded the matter for consideration of extrinsic evidence to resolve this ambiguity.

California Court Rules That State Statutory Law Bars Coverage For Lead Paint Public Nuisance Claims

A California trial court ruled that a state statute precluding insurance coverage for losses "caused by the willful act of the insured" applied to lead paint public nuisance claims. *Certain Underwriters at Lloyd's of London v. ConAgra Grocery Products Co.*, No. CGC-14-536731 (Cal. Super. Ct. Feb. 26, 2020).

In the underlying lead paint litigation, the People of Santa Clara asserted a public nuisance claim based on the promotion of lead paint. In a series of decisions, California trial and appellate courts ruled that paint manufacturer W.P. Fuller & Co. willfully promoted lead paint with actual knowledge of its hazards and that ConAgra was liable as Fuller's successor. An appellate court directly rejected ConAgra's assertion that Fuller lacked actual knowledge of the dangers of lead paint, finding that the factual evidence contradicted that contention.

In the present case, a California trial court held that, based on the aforementioned rulings, insurance coverage for the underlying nuisance claim was barred by California Insurance Code § 533, which states that an "insurer is not liable for a loss caused by the willful act of an insured." The court rejected ConAgra's argument that it was insulated from its predecessor's knowledge, noting that under the Insurance Code, a successor entity "acquires the liabilities of its predecessor and [is] responsible as the wrongdoer." In addition, the court dismissed ConAgra's assertion that the findings in the previous rulings did not meet Section 533's willfulness standard and that Fuller's conduct was merely "reckless." Finally, the court deemed it irrelevant that Fuller's senior managers might not have known about the hazards of lead paint. The court stated: "This is not a punitive damages case in which such issues can be relevant. Instead, for Insurance Code § 533 purposes, an entity's employees' collective knowledge—not just senior managers' knowledge—is what matters."

Property Policy Alerts:

Exclusions Cannot Create Ambiguity Where Named Perils Provision Does Not Encompass Damage At Issue, Says New Jersey Appellate Court

A New Jersey appellate court ruled that the "named perils" clause in a property policy did not cover water leak damage and that policy exclusions could not create ambiguity where the coverage provision was clear. *Cusamano v. New Jersey Ins. Underwriting Assoc.*, 2020 WL 1026748 (N.J. App. Div. Mar. 3, 2020).

Homeowners filed a claim with their property insurer for water damage caused by a leaking pipe. A plumber determined that the leak was caused by a "rotted connection" in the drain line. When the insurer denied coverage, the homeowners filed suit, alleging breach of contract and bad faith. A trial court ruled that the policy was ambiguous because it listed several excluded perils, which did not include water damage (except as to breakage of water pipes by explosion). The trial court reasoned that because the policy failed to list water damage from leaking pipes as an excluded peril, the homeowners had a "reasonable expectation of coverage" for such losses.

The appellate court reversed, ruling that the trial court erred by considering exclusionary clauses in order to find ambiguity when the coverage-granting clause unambiguously did not encompass the water damage at issue. The appellate court emphasized that an exclusion operates to limit or restrict the insuring clause, and "does not extend or grant coverage." The court stated: "the covered perils defined the outer bounds of coverage. The exclusions pertain only to what is covered. . . . Because water damage was not a covered peril, there was no reason to consider the policy's exclusions."

Supreme Court Of North Carolina Rules That Actual Cash Value Unambiguously Includes Depreciation Of Labor

As discussed in previous Alerts, the Supreme Courts of Tennessee, Arkansas, Minnesota and Nebraska have addressed whether and under what circumstances labor costs can be depreciated for the purposes of calculating actual cash value ("ACV") under a property policy. *See* April 2019 Alert, March 2017 Alert, January and February 2016 Alerts. Last month, the Supreme Court of North Carolina weighed in, ruling that an ACV provision is unambiguous and includes the depreciation of labor. *Accardi v. Hartford Underwriters Ins. Co.*, 2020 WL 987541 (N.C. Feb. 28, 2020).

The homeowners submitted a claim to Hartford for damage caused by a hailstorm. Hartford issued an ACV payment of $6,743.36, which reflected the total estimated cost of repair ($10,287.28), less the deductible ($500) and depreciation of both labor and materials ($3,043.92). The homeowners argued that in calculating ACV, Hartford should have separated the costs of labor and materials and depreciated only the material items. The homeowners sought to represent a class of North Carolina residents to whom Hartford paid ACV payments based on depreciation of both labor and materials. A lower court dismissed the suit and the North Carolina Supreme Court affirmed.

Although the term ACV was not defined in the "definitions" section of the policy, a roof coverage endorsement stated that:

> your policy includes Actual Cash Value (ACV) Loss Settlement for covered windstorm or hail losses to your Roof. This means if there is a covered windstorm or hail loss to your roof, [Hartford] will deduct depreciation from the cost to repair or replace the damaged roof. In other words, [Hartford] will reimburse for the actual cash value of the damaged roof surfacing less any applicable policy deduction.

The court concluded that this definition "must be read in harmony with the remainder of the policy" and is unambiguous in allowing depreciation of both labor and materials.

Cyber Alert:

"Voluntary Parting" Exclusion Bars Coverage For Email Phishing Wire Transfer Loss, Says Virginia Court

A Virginia federal district court ruled that losses arising from a wire transfer induced by a fraudulent email were excluded by a "voluntary parting" exclusion, and were not otherwise covered by a Forgery endorsement. *Midlothian Enterprises, Inc. v. Owners Ins. Co.*, 2020 WL 836832 (E.D. Va. Feb. 20, 2020).

A Midlothian employee received an email, purportedly from the company president, instructing her to wire money to a bank account in Alabama. After the transfer was made, the company discovered that the email was fraudulent. Owners Insurance denied coverage based on an exclusion that barred coverage for "[l]oss resulting from your, or anyone acting on your express or implied authority, being induced by any dishonest act to voluntarily part with title to or possession of any property." The court agreed and granted the insurer's summary judgment motion.

The court rejected Midlothian's contentions that the exclusion was ambiguous and that a victim of fraud can never act voluntarily. Additionally, the court dismissed Midlothian's assertion that the exclusion did not apply because the employee did not act with express or implied authority when she effectuated the wire transfer. The court explained that "[t]he fact that another individual pretended to authorize the transaction does not negate the voluntariness of the transfer." Finally, the court ruled that there was no coverage under a separate Forgery or Alteration Endorsement. The endorsement defined "covered instruments" as "checks, drafts, promissory notes, or similar written promises, orders or directions to pay a sum certain in money." The court held that an email directing a wire transfer is not a "covered instrument" because it is not "of the same import as that of the specific item[s] posted."

Occurrence Alerts:

Seventh Circuit Rules That Policyholder's Shipment Of Non-Certified Lumber, Resulting In Damage To Other Property, Is Not An Occurrence

The Seventh Circuit ruled that a policyholder's shipment of lumber that was not certified in accordance with state testing requirements, resulting in its removal and damage to other property, was not a covered occurrence. *Lexington Ins. Co. v. Chicago Flameproof & Wood Specialties Corp.*, 2020 WL 948509 (7th Cir. Feb. 27, 2020).

Chicago Flameproof, a distributor of fire retardant lumber, was sued in three lawsuits stemming from the company's sale of lumber to contractors. The complaints alleged that the contractors ordered a specific brand of fire retardant lumber that met the requirements set forth in the International Building Code ("IBC"), but that Chicago Flameproof instead delivered its in-house brand, which was not IBC-approved. The complaints further alleged that the contractors were not aware of this substitution until after the lumber had been installed in the building projects. The lumber was ultimately removed and replaced with IBC-certified lumber, allegedly causing damage to the surrounding materials. Lexington sought a declaration that it had no duty to defend the suits, arguing that Chicago Flameproof's knowing decision to supply non-IBC-compliant lumber was not a covered "occurrence." An Illinois federal district court agreed and granted the insurer's summary judgment motion. The Seventh Circuit affirmed.

The Seventh Circuit reasoned that the underlying complaints did not allege any unforeseen or unexpected insurable events because Chicago Flameproof shipped the uncertified lumber deliberately and was aware or should have been aware of the consequences of that action. The court acknowledged that under Illinois law, faulty workmanship may constitute an occurrence if it results in damages separate and apart from the insured's work product, or if the insured was unaware of the defective nature of a building component. However, neither of those principles apply where, as here, the policyholder allegedly made a deliberate decision to ship non-conforming products.

The court rejected Chicago Flameproof's assertion that a duty to defend was triggered based on allegations of negligence in the underlying complaints. The court reasoned that the negligence "label" is of little significance given that the crux of the allegations is that Chicago Flameproof acted deliberately.

Intentional Shooting Of Guns Is A Covered "Occurrence" And Insurer's Refusal To Defend Policyholder Constituted Bad Faith, Says Washington Appellate Court

Reversing a lower court decision, a Washington appellate court ruled that a property insurer acted in bad faith in refusing to defend a lawsuit alleging that the homeowners shot guns onto neighboring property, finding that the alleged conduct constituted a covered occurrence. *Webb v. USAA Casualty Ins. Co.*, 2020 WL 812137 (Wash. Ct. App. Feb. 19, 2020).

A lawsuit against the Webbs alleged that they and others carelessly and recklessly shot multiple rounds of ammunition onto neighboring property. The complaint alleged that the Webbs were advised about the dangers of this conduct, but nevertheless continued to engage in this "ultra-hazardous activity." Plaintiffs asserted seven causes of action, including trespass, assault, negligent and intentional infliction of emotional distress, nuisance and violation of county penal regulations. When USAA denied coverage, the Webbs sued USAA for breach of contract, bad faith, and violation of the Insurance Fair Conduct Act ("IFCA") and the Consumer Protection Act ("CPA"). A Washington trial court granted USAA's summary judgment motion, finding that the underlying claims arose from intentional acts outside the scope of policy coverage. The appellate court reversed.

The appellate court ruled that USAA had a duty to defend the suit because it alleged covered "personal injury," defined to include "wrongful entry." The court reasoned that allegations of trespass and nuisance constituted claims for wrongful entry. In addition, the court ruled that the complaint alleged an "occurrence," defined as an "accident" or "an event or series of events . . . proximately caused by an act or omission of any 'insured,' which results, during the policy period, in 'personal injury,' neither expected nor intended from the standpoint of the insured." The court deemed it irrelevant that the complaint did not allege an "accident," finding that the occurrence requirement is satisfied if the Webbs' actions resulted in injury that was unexpected or unintended from their own subjective perspective. The court stated:

> the complaint alleged that the target shooters acted carelessly and recklessly, but not that they actually knew that bullets were entering the [adjoining] property. . . . Although the shooting was deliberate, the Webbs must have expected or intended the personal injury—here trespass and/or nuisance—to negate the existence of an occurrence.

The court also ruled that coverage was not barred by a clause excluding conduct that is "malicious or criminal in nature." Although the complaint alleged violations of the local penal code, the court held that (1) the complaint was ambiguous as to whether the Webbs' actions constituted actual violations of those statutes, and (2) even if they did, criminal act exclusions "apply only to serious crimes involving some malicious or wrongful mental state." The court therefore granted the

Webbs' summary judgment motion as to the duty to defend.

Finally, the court ruled in the Webbs' favor on their bad faith, IFCA and CPA claims. The court concluded that USAA's defense denial was "unreasonable, frivolous, or unfounded" because its positions on the "occurrence" and "expected or intended" issue were contradicted by controlling law, based on a "questionable interpretation of policy language," and/or unsupported by the allegations in the complaint.

Coronavirus Alert:

Has There Been "Physical Damage" By A Covered Peril?

As the respiratory illness known as coronavirus disease 2019 ("COVID-19") spreads across the globe, so too are its major impacts on businesses, financial markets, and international trade and commerce. Businesses are confronting a range of losses related to the World Health Organization-declared pandemic and will look to insurance to cover those losses. While insurers' coverage decisions will be fact-specific and based on the terms and conditions of the relevant policy, whether there has been physical damage caused by a covered peril is likely to be at the forefront of early disputes.

Business Interruption Coverage

Policyholders will reflexively look to business interruption coverage when normal business operations are interrupted. Commercial property insurance policies often insure against a loss of business income caused by covered physical damage to the insured's own property. In the context of COVID-19-related losses, disputes may arise as to whether the loss of use of property that has become uninhabitable or unusable because of COVID-19 contamination sustained a "physical loss" for purposes of business interruption coverage. In instances where a facility is quarantined or closed down in an attempt to minimize the spread of COVID-19, policyholders are likely to argue that the "physical loss or damage" requirement has been satisfied for business interruption coverage purposes.

In other contexts, courts have ruled that property contamination caused by harmful airborne particles is sufficient to constitute direct physical loss. *See, e.g., Sullivan v. Standard Fire Ins. Co.*, 956 A.2d 643 (De. 2008) (mold contamination constitutes a physical loss under property policy); *Farmers Ins. Co. of Oregon v. Trutanich,* 858 P.2d 1332 (Or. Ct. App. 1993) (pervasive odors from amphetamine laboratory are a direct physical loss); *Matzner v. Seaco Ins. Co.*, 9 Mass. L. Rptr. 41 (Mass. Super. Ct. 1998) (direct physical loss or damage encompasses carbon monoxide contamination); *Motorists Mut. Ins. Co. v. Hardinger*, 2005 WL 1163426 (2d Cir. 2005) (presence of E. coli in water well of residence, which caused physical illness to inhabitants, could constitute physical loss or damage to property); *Gregory Packaging Inc. v. Travelers Prop. Cas. Co. of Am.*, 2014 WL 6675934 (D.N.J. Nov. 25, 2014) (release of ammonia in building constituted direct physical loss because it "physically transformed" the air and rendered the property unusable). These courts have reasoned that "physical loss or damage" may include changes or alterations to property that are intangible and/or invisible to the naked eye.

However, this body of case law is not necessarily controlling in the context of COVID-19-related closures. The question of whether the presence of COVID-19 in insured property is deemed to constitute "physical loss or damage" will ultimately depend several factors, including most significantly, the particular facts related to the property at issue, applicable policy language, and governing law. Additionally, the question of whether COVID-19 contamination can be classified as "physical" will turn on the scientific consensus that develops around the virus and its transmission. To the extent that contamination has occurred through accumulation of microscopic viral particles on surfaces, such as floors, desks and equipment, or through ventilation systems, a policyholder will make a case for "physical loss or damage." Conversely, where business closures have occurred preventatively prior to any actual contamination, or where policies limit the scope of insured property in important respects, coverage may be unavailable. *See Universal Image Productions, Inc. v. Federal Ins. Co.*, 475 F. App'x 569 (6th Cir. 2012) (insured did not suffer "direct physical loss or damage" as a result of mold and bacterial contamination in ventilation system because premises were not rendered completely uninhabitable and because policy defined "building" and "personal property" to exclude "air, either inside or outside of a structure").

In addition to the physical loss condition, most policies will require the damage to be caused by a "peril not otherwise excluded" in order to trigger business interruption coverage. Therefore, policy exclusions may preclude coverage for business interruption losses, even where such losses arise from physical loss. Moreover, if losses are arguably caused by a combination of multiple factors, coverage decisions will become significantly more complicated, likely involving application of ensuing loss and concurrent causation provisions. Finally, regardless of causation, valuation issues relating to proof and extent of business interruption loss are likely to create complicated litigation issues.

Contingent Business Interruption Coverage

Property insurance policies also typically include provisions that insure against a loss resulting from interruption to a policyholder's supply chain or network because of damage to the supplier's property. Contingent business interruption coverage insures against losses sustained by an insured's supplier, distributor or customer, rather than the policyholder itself. Given the reality of today's global economy, contingent business interruption provisions are likely to be implicated in losses stemming from COVID-19-related closures. All of the same issues that are likely to arise in the context of business interruption coverage are similarly present in the contingent business interruption coverage context.

The outcome of any such COVID-19 litigation will undoubtedly be fact-dependent, based on an evaluation of applicable policy language as applied to the record presented, and in accordance with governing jurisdictional law. Overall, early on industry observers do not foresee a major effect on the property insurance market from insured claims. According to Moody's, "global P&C commercial lines exposure is limited with modest insured losses relative to economic losses." With respect to the domestic market, Fitch Ratings predicts that COVID-19 is unlikely to have an "adverse impact on financial results reported by U.S. P&C companies, nor their ratings," explaining that "the nature of insured commercial exposures, along with restrictive language embedded in policy contracts, will likely limit U.S. P&C companies from a material level of claims."[1]

1. *U.S. P&C insurers face 'limited exposures' from coronavirus*, PropertyCasualty360 (Mar. 13, 2020), https://www.propertycasualty360.com/2020/03/13/u-s-pc-insurers-face-limited-exposures-from-coronavirus/?slreturn=20200214150727.

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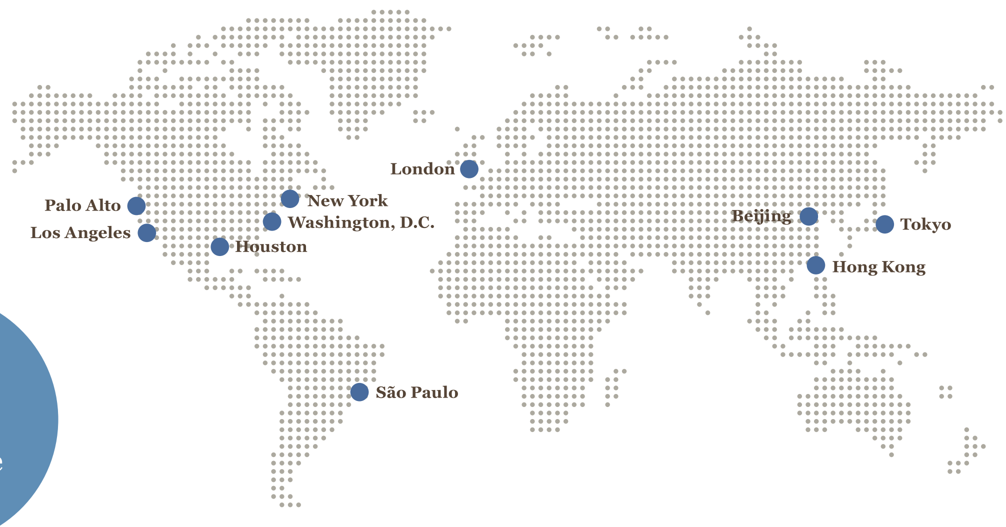

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