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Insurance Law Alert

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In This Issue

New York District Court Rules That Excess Policies' Exhaustion Provisions Require Actual Payment of Underlying Limits

A New York federal bankruptcy court ruled that three excess policies unambiguously required actual payment of underlying policy limits before liability attached. *Rapid-American Corp. v. Travelers Cas. & Sur. Co.*, 2016 WL 3292355 (Bankr. S.D.N.Y. June 7, 2016). (Click here for full article)

"They're the go-to firm for the insurance industry for really serious cases. Their practice is top-notch."

–Chambers USA 2016, quoting a client

Arizona District Court Rules That Cyber Policy Does Not Cover Assessments Imposed in Connection with Data Breach

An Arizona federal district court granted an insurer's summary judgment motion, ruling that a cyber policy did not provide coverage for assessments imposed by a credit card association in connection with a data breach. *P.F. Chang's China Bistro, Inc. v. Federal Ins. Co.*, 2016 WL 3055111 (D. Ariz. May 31, 2016). (Click here for full article)

Two Courts Reject Waiver Arguments, Finding That Insurers Properly Reserved Rights to Deny Coverage

In two decisions issued last month, Courts of Appeals for the Tenth and Third Circuits rejected policyholders' waiver arguments and held that property insurers were not estopped from denying coverage based on policy exclusions. *Gallegos v. Safeco Ins. Co. of Am.*, 2016 WL 2849417 (10th Cir. May 16, 2016); *Nationwide Prop. & Cas. Ins. Co. v. Shearer*, 2016 WL 3018764 (3d Cir. May 26, 2016). (Click here for full article)

Ninth Circuit Asks Nevada Supreme Court to Address Scope of Damages for Insurer's Breach of Duty to Defend

The Ninth Circuit asked the Nevada Supreme Court to decide whether an insurer that breached its duty to defend, but did not act in bad faith, is liable for all consequential losses arising from that breach, including sums in excess of policy limits. *Nalder v. United Auto. Ins. Co.*, 2016 WL 3082417 (9th Cir. June 1, 2016). (Click here for full article)

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Ruling that the phrase "arising out of" in a policy exclusion required only a causal connection rather than proximate causation, the Ninth Circuit held that a business exclusion relieved an insurer of its duty to defend a suit based on credit card disputes that arose in connection with the policyholder's employment. *Griggs v. Allstate Ins. Co.*, 2016 WL 3002302 (9th Cir. May 25, 2016). (Click here for full article)

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The Supreme Court of Iowa ruled that defective work resulting in property damage performed by an insured's subcontractor may constitute an occurrence under a liability policy. *National Surety Corp. v. Westlake Investments, LLC*, 2016 WL 3201729 (Iowa June 10, 2016). (Click here for full article)

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Illinois Appellate Court Finds Conflict Between Illinois and Indiana Law As to Notice Requirements for Policy Exclusions

An Illinois appellate court ruled that Indiana and Illinois law differed regarding the notice required when an exclusion is added to an insurance policy at the time of renewal, holding that the law of Indiana governed the dispute. *Cincinnati Ins. Co. v. Chapman*, 2016 WL 2986193 (Ill. App. 1st Div. May 23, 2016). (Click here for full article)

New York Court of Appeals Declines to Expand Common Interest Exception to Waiver of Privilege

The New York Court of Appeals ruled that to maintain privilege under the common interest doctrine, it is not enough that the parties share a common legal interest; rather, the communication at issue must also relate to pending or anticipated litigation. *Ambac Assurance Corp. v. Countrywide Home Loans, Inc.*, 2016 WL 3188989 (N.Y. June 9, 2016). (Click here for full article)

Excess Coverage Alert:

New York District Court Rules That Excess Policies' Exhaustion Provisions Require Actual Payment of Underlying Limits

A New York federal bankruptcy court ruled that three excess policies unambiguously required actual payment of underlying policy limits before liability attached. *Rapid-American Corp. v. Travelers Cas. & Sur. Co.*, 2016 WL 3292355 (Bankr. S.D.N.Y. June 7, 2016).

Rapid-American, the successor to a manufacturer of asbestos-containing products, was sued in thousands of personal injury actions. Rapid-American settled many claims, but ultimately declared bankruptcy. Several of Rapid-American's insurers also became insolvent and were unable to pay the limits of their policies. Rapid-American filed a declaratory judgment action seeking a ruling as to coverage for certain excess policies. The excess insurers argued, among other things, that no coverage under their policies was available because Rapid-American had not exhausted underlying insurance. The court agreed and granted the insurers' partial summary judgment motion.

The court held that the language in each excess policy required actual payment of the underlying limits. A policy issued by St. Paul provided that excess coverage does not attach "until the amount of the applicable underlying limit has been paid by or on behalf of the Insured." A National Union policy (1977) conditioned payment on exhaustion of underlying limits "by reason of losses paid thereunder." Another National Union policy (1984) did not unambiguously require exhaustion, but Rapid-American conceded at oral argument that the policy required exhaustion of underlying limits. Therefore, the court held that, even assuming that Rapid-American had accrued liabilities that reached excess levels, excess coverage was unavailable because actual payment of underlying limits had not been made.

The court rejected several arguments frequently asserted by policyholders in this context. First, the court held that *Zeig v. Mass. Bonding & Ins. Co.*, 23 F.2d 665 (2d Cir. 1928), a case commonly cited for the proposition that exhaustion does not require actual payment, was distinguishable because it involved a first-party property policy. The court further noted that *Zeig*'s "continuing vitality is open to question" in the wake of recent decisions to the contrary. *See Ali v. Fed. Ins. Co.*, 719 F.3d 83 (2d Cir. 2013) (discussed in June 2013 Alert); *Forest Labs., Inc. v. Arch Ins. Co.*, 953 N.Y.S.2d 460 (N.Y. Sup. Ct. 2012), *aff'd*, 984 N.Y.S.2d 361 (N.Y. App. Div. 2014) (discussed in October 2012 Alert).

Second, the court rejected Rapid-American's argument that a Bankruptcy Clause and corresponding New York statutory law precluded the insurers from relying on the exhaustion requirement. The court explained that the Bankruptcy Clause precludes insurers from refusing to pay claims on policies of insolvent policyholders but does not excuse compliance with conditions precedent (such as exhaustion) imposed by excess policies. The court distinguished cases that have excused a policyholder's payment of a self-insured retention in the case of bankruptcy. The court explained that in those cases, bankruptcy prevented the policyholder from satisfying the SIR, whereas here the exhaustion requirement could have been satisfied by payment of underlying limits by a party other than Rapid-American.

Finally, the court rejected the contention that a Maintenance Clause precluded the excess insurers from requiring exhaustion or, alternatively, created ambiguity as to the exhaustion requirement. The court held that the Maintenance Clause, which states that coverage will not "drop down" in the event that the policyholder fails to maintain a lower level policy, was inapplicable because a "settlement with an underlying insurer does not constitute a failure to maintain the underlying policy, and does not excuse the condition precedent imposed by an exhaustion requirement."

Data Breach Alert:

Arizona District Court Rules That Cyber Policy Does Not Cover Assessments Imposed in Connection with Data Breach

An Arizona federal district court granted an insurer's summary judgment motion, ruling that a cyber policy did not provide coverage for assessments imposed by a credit card association in connection with a data breach. *P.F. Chang's China Bistro, Inc. v. Federal Ins. Co.*, 2016 WL 3055111 (D. Ariz. May 31, 2016).

Federal Insurance Company issued a cyber-security policy to P.F. Chang's parent company. When computer hackers obtained credit card numbers belonging to P.F. Chang's customers, the restaurant notified Federal. Federal reimbursed P.F. Chang's more than $1.7 million pursuant to the policy but P.F. Chang's also sought coverage for nearly $2 million in assessments that it paid to Bank of America Merchant Services ("BAMS") pursuant to an indemnification agreement. The agreement, known as a Master Service Agreement ("MSA"), allowed BAMS to processes P.F. Chang's credit card transactions and provided that P.F. Chang's would pay for any fines, penalties or fees imposed on BAMS by credit card associations. Federal denied coverage for the assessments, arguing that the policy did not cover such expenses, and, alternatively, that exclusions barred coverage for such payments. The court agreed.

The court held that a policy provision covering loss arising out claims made against P.F. Chang's for "Privacy Injury" did not cover the assessment charges. The court reasoned that BAMS, as a third-party credit card processing vendor, did not have a valid claim for Privacy Injury against P.F. Chang's because its own records were not breached. Rather, the records of the banks that issued the credit cards were breached. The court reached a different conclusion with respect to a policy provision covering Privacy Notification Expenses and Extra Expenses, finding that those clauses provided coverage for certain assessments. However, the court held that policy exclusions relating to liability assumed by contract or agreement barred coverage because P.F. Chang's liability for the assessments arose directly out of the MSA with BAMS. In so ruling, the court rejected P.F. Chang's argument that the contractual liability exclusion did not apply because it would have been liable under negligence or equitable doctrines for the assessments imposed against BAMS even without the MSA. Finally, the court rejected P.F. Chang's reasonable expectations argument, finding that it failed to establish that its expectation of coverage for the assessments was "objectively reasonable."

Waiver Alert:

Two Courts Reject Waiver Arguments, Finding That Insurers Properly Reserved Rights to Deny Coverage

In two decisions issued last month, Courts of Appeals for the Tenth and Third Circuits rejected policyholders' waiver arguments and held that property insurers were not estopped from denying coverage based on policy exclusions.

In *Gallegos v. Safeco Insurance Co. of America,* 2016 WL 2849417 (10th Cir. May 16, 2016), the Tenth Circuit rejected a homeowner's argument that a property insurer waived its right to rely on certain exclusions in denying coverage because it failed to specify those exclusions in its reservation of rights letter.

Homeowners sought coverage from Safeco for roof and ceiling damage following a storm. Safeco denied coverage on the basis that the damage was caused by poor construction and other events pre-dating coverage, rather than the snow storm. In its reservation of rights, Safeco identified several exclusions relevant to its denial. The homeowners filed suit. During the course of litigation, Safeco paid the homeowners approximately $10,000 in repair costs. Thereafter, a Colorado district court granted Safeco's summary judgment motion, finding that improper construction and maintenance of the roof contributed to the damage, and that under the policy's anti-concurrent causation clause, Safeco was not liable for damage caused in part by an excluded peril.

On appeal, the homeowners argued that Safeco had waived reliance on the relevant exclusions by failing to specifically identify

them in the reservation of rights and/or by paying the costs of the roof repair during the litigation. The Tenth Circuit rejected these assertions and affirmed the district court. The Tenth Circuit concluded that the coverage denial sufficiently raised each exclusion relied upon by Safeco during litigation. The court further held that even if the reservation of rights had not properly preserved the relevant exclusions by name, that failure would not estop Safeco from denying coverage. The court explained that under Colorado law, an insurer can waive a defense that constitutes a "forfeiture of a policy," but that "coverage and exclusion issues are not subject to waiver." Finally, the court ruled that Safeco's voluntary payment of the repair costs during litigation did not constitute an admission of liability or operate to waive Safeco's right to deny coverage, explaining that waiver cannot be invoked to create coverage where none existed under the policy.

The Third Circuit rejected a different waiver/estoppel argument in *Nationwide Property & Casualty Insurance Co. v. Shearer*, 2016 WL 3018764 (3d Cir. May 26, 2016). There, the policyholders were sued for trespass, nuisance and violations of environmental statutes based on sewage leaks onto neighboring property. Nationwide defended the suit under a reservation of rights that expressly stated that pollution or other exclusions might apply. In a supplemental reservation letter, Nationwide cautioned that it reserved its right to deny coverage and withdraw from the defense if valid bases for doing so arose. More than two years after the underlying suit began, Nationwide sought a declaration that it had no duty to defend based on the pollution and biological deterioration exclusions. The policyholders did not dispute application of the exclusions but argued that Nationwide was estopped from withdrawing a defense because "such an untimely withdrawal would prove prejudicial." The court disagreed and granted Nationwide's summary judgment motion. The Third Circuit affirmed.

The Third Circuit ruled that the policyholders failed to establish equitable estoppel under Pennsylvania law. In particular, the court held that the policyholder did not establish "inducement" by virtue of the fact that Nationwide provided a defense for more than two years. The court explained that any claim of inducement was defeated by Nationwide's express reservation of rights, notwithstanding its long-term defense of the underlying suit. The court also ruled that the policyholders could not establish the requisite prejudice, explaining that although the policyholders "were understandably disappointed by Nationwide's decision to withdraw its defense, the fact that it was entitled to do so under the terms of the insurance contracts means that the defense it did tender was a temporary benefit" to the policyholders.

Defense Alerts:

Ninth Circuit Asks Nevada Supreme Court to Address Scope of Damages for Insurer's Breach of Duty to Defend

The Ninth Circuit asked the Nevada Supreme Court to decide whether an insurer that breached its duty to defend, but did not act in bad faith, is liable for all consequential losses arising from that breach, including sums in excess of policy limits, or whether such liability is capped at policy limits plus defense costs. *Nalder v. United Auto. Ins. Co.*, 2016 WL 3082417 (9th Cir. June 1, 2016).

The coverage dispute arose from an automobile accident in which Lewis ran over a minor. The minor's father contacted United Auto, Lewis's insurer, and offered to settle for the $15,000 policy limit. United Auto refused, based on its position that Lewis was not covered at the time of the accident because he had failed to timely renew his policy. United Auto did not inform Lewis of the offer. Thereafter, the victim sued Lewis. Lewis did not defend the suit and a $3.5 million default judgment was entered against him. The victim and Lewis then sued United Auto for breach of contract and bad faith, among other claims. A Nevada district court judge initially ruled in United Auto's favor, but on remand from the Ninth Circuit held that the renewal provision was ambiguous and that Lewis was covered under the policy at the time of the accident. The court ordered United Auto to pay the $15,000 policy limit but held that it was not liable for consequential damages because Lewis chose not to defend himself in the underlying suit and did not incur any defense costs.

On appeal, the parties disputed whether United Auto was liable for the $3.5 million

default judgment as consequential damages stemming from its failure to defend. Noting the absence of binding Nevada precedent in this context, and conflicting lower court decisions, the Ninth Circuit certified the following question to the Nevada Supreme Court:

> Whether, 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 is the insurer liable for all losses consequential to the insurer's breach?

We will keep you apprised of further developments in this matter.

Second Circuit Rules That Insurer Must Defend Personal and Advertising Injury Class Action Suits Notwithstanding Policy Exclusions

Reversing a New York district court decision, the Second Circuit ruled that an insurer was obligated to defend suits alleging that the policyholder violated statutory and common law by transferring private customer information for profit. *National Fire Ins. Co. of Hartford v. E. Mishan & Sons, Inc.*, 2016 WL 3079958 (2d Cir. June 1, 2016).

Emerson was sued in two class actions suits alleging fraud, breach of contract, unjust enrichment and various statutory violations based on its participation in the transfer of private consumer credit card information. Emerson's general liability insurers refused to defend on the basis of a policy exclusion barring coverage for personal and advertising injury "caused by or at the direction of the insured with the knowledge that the act would violate the rights of another." A New York federal district court agreed, finding that all of the allegations in the underlying suits fell within the scope of the knowing violation exclusion. The Second Circuit reversed.

The Second Circuit ruled that the knowing violation exclusion did not apply because some of the underlying causes of action did not require knowing or intentional conduct as an element. The court explained that although the class actions suits generally alleged intentional conduct, the factual allegations did not rule out the possibility of a finding that Emerson acted without intent to harm. In particular, the court noted that claims for unjust enrichment and breach of contract do not require a showing of intentional conduct. Therefore, Emerson could be found liable in the underlying suits even absent evidence that it knowingly violated its customers' right to privacy. Having found that at least some claims were potentially within the scope of coverage, the court ruled that the insurers were required to defend the actions in their entirety.

Ninth Circuit Rules That Business Exclusion Bars Coverage for Underlying Credit Card Dispute

The Ninth Circuit ruled that the phrase "arising out of" in a policy exclusion required only a causal connection rather than proximate causation and, therefore, that a business exclusion relieved an insurer of its duty to defend a suit based on credit card disputes that arose in connection with the policyholder's employment. *Griggs v. Allstate Ins. Co.*, 2016 WL 3002302 (9th Cir. May 25, 2016).

Bryan Griggs was employed by HDMC, a company that purchases hotel rooms in bulk for resale to convention attendees. In order to reserve the rooms, HDMC used its corporate credit cards. However, on certain occasions, Griggs gave HDMC permission to use his personal credit card to reserve rooms. At one point, Griggs had reason to believe that HDMC was using his credit card without his authorization and thus withdrew permission for use of his card. Several months later, HDMC fired Griggs and then sued him, alleging that he wrongfully disputed charges that he had authorized and for which he had been reimbursed. Griggs tendered defense of the action to Allstate pursuant to a renters policy. The policy covered losses arising out of the unauthorized use of a credit card, but excluded coverage for "any loss arising from any business of an insured person." Allstate denied coverage and refused to defend based on the exclusion. In ensuing litigation, an Oregon federal district court granted Allstate's summary judgment motion, concluding that the business exclusion applied. The Ninth Circuit affirmed.

The Ninth Circuit ruled that the credit card losses at issue arose from Griggs's business

(*i.e.,* his employment with HDMC). The court explained that under Oregon law, the phrase "arising out of" indicates a causal connection rather than proximate causation. Finding that the exclusion squarely applied, the court stated, "[a]ny losses Griggs sustained from HDMC's unauthorized use of Griggs's credit card arose from—that is, were causally connected to—his full-time, paid employment at HDMC."

Construction Defect Alert:

Iowa Supreme Court Rules That Faulty Workmanship May Constitute an "Occurrence" Under Excess Liability Policy

The Supreme Court of Iowa ruled that defective work resulting in property damage performed by an insured's subcontractor may constitute an occurrence under a liability policy. *National Surety Corp. v. Westlake Investments, LLC*, 2016 WL 3201729 (Iowa June 10, 2016).

National Surety sought a declaration that it was not liable to the assignee of an excess liability policy for damages awarded in underlying construction defect litigation. National Surety argued that property damage caused by defective workmanship could not constitute a covered occurrence under Iowa law. Both parties moved for summary judgment, and the district court ruled in favor of Westlake, the policyholder's assignee. A jury later ruled in favor of Westlake, awarding it approximately $12.5 million plus interest. National Surety appealed on numerous grounds, and an intermediate appellate court affirmed in relevant part. The Iowa Supreme Court exercised discretion to consider one issue: whether the district court erroneously instructed the jury as to what constitutes an occurrence under National Surety's policy.

The district court had instructed the jury that the term "accident" means "an unplanned, sudden, and unexpected event . . . determined from the viewpoint of the insureds and what they intended or should reasonably have expected." The district court had further instructed that "[d]efective construction work performed by an insured is not covered by the policy; however, defective construction work performed by subcontractors may be an 'occurrence' under the policy." The Iowa Supreme Court ruled that the district court did not err in directing the jury to consider the subjective viewpoint of the insured in determining whether there was an "accident." In addition, the Iowa Supreme Court ruled that the district court did not err in stating that defective work performed by an insured's subcontractor may constitute an occurrence. The court reasoned that certain exclusions in the policy (such as a "your work" exclusion) supported its interpretation, explaining that it "would be illogical for an insurance policy to contain an exclusion negating coverage its insuring agreement did not actually provide or an exception to an exclusion restoring it." Notably, the court distinguished cases in which courts have ruled that faulty workmanship does not constitute an occurrence because the insured was the general contractor and the property damage was limited to the insured's own work product.

Punitive Damages Alert:

California Supreme Court Rules That Post-Trial Award of Attorneys' Fees May Be Included in Calculation of Compensatory-Punitive Damage Ratio

The California Supreme Court ruled that a post-verdict award of attorneys' fees in a coverage action should be considered compensatory damages in determining whether a punitive award is unconstitutionally excessive. *Nickerson v. Stonebridge Life Ins. Co.*, 2016 WL 3192499 (Cal. June 9, 2016).

A policyholder sued his health insurer for breach of contract and bad faith based on its failure to pay full benefits for an extended hospital stay. Before trial, the parties stipulated that if the policyholder succeeded, the trial court would determine the amount of attorneys' fees to which he was entitled under California precedent. *See Brandt v. Superior Court*, 37 Cal. 3d 813 (Cal. 1985) (when an insurer refuses to pay

policy benefits in bad faith, attorneys' fees reasonably incurred in obtaining benefits are recoverable as an element of compensatory damages). Following trial, the court issued a directed verdict on the policyholder's breach of contract claim, awarding him $31,500. With respect to the bad faith claim, the jury awarded the policyholder $35,000 for emotional distress and $19 million in punitive damages. After the jury rendered its verdict, the court awarded the policyholder $12,500 in *Brandt* fees.

The trial court ruled that the punitive damages award was unconstitutionally excessive. In calculating a permissible award, the court considered only the $35,000 compensatory damage award, and not the $12,500 in *Brandt* fees. An intermediate appellate court affirmed. The appellate court acknowledged that *Brandt* fees are properly considered compensatory damages for purposes of evaluating a punitive-compensatory damage ratio, but held that such fees could not be included in the calculation where, as here, they are awarded after the jury issues a punitive damage award. The California Supreme Court reversed. Finding "no apparent reason" why a court applying the constitutional guidelines may not consider a post-verdict compensatory damage award in its calculus, the court stated that "to exclude the fees from consideration would mean overlooking a substantial and mutually acknowledged component of the insured's harm."

Choice of Law Alert:

Illinois Appellate Court Finds Conflict Between Illinois and Indiana Law As to Notice Requirements for Policy Exclusions

An Illinois appellate court ruled that Indiana and Illinois law differed regarding the notice required when an exclusion is added to an insurance policy at the time of renewal, and that the law of Indiana governed the dispute. *Cincinnati Ins. Co. v. Chapman*, 2016 WL 2986193 (Ill. App. 1st Div. May 23, 2016).

In 2008, Chapman filed a class action suit against C.T. Phoenix alleging violations of the Telephone Consumer Protection Act. Cincinnati, Phoenix's general liability insurer, denied coverage based on an exclusion barring coverage for TCPA violations. The exclusion had been added to the policy when it was renewed in 2006. In ensuing litigation, the parties disputed whether Indiana or Illinois law should govern the dispute. An Illinois trial court determined that the law of the forum state (Illinois) applied after finding that there was no conflict between the two states' laws. Under Illinois law, an insurer must provide 30 days advance notice of a new exclusion in a renewal policy. Because such notice was not provided here, the court ruled that the TCPA exclusion was not valid. The appellate court reversed.

The appellate court ruled that an actual conflict existed between Illinois and Indiana as to an insurer's duty to provide notice of

a new exclusion in a renewal policy. Illinois law requires an insurer to provide 30 days advance notice, whereas Indiana does not. Although there was no Indiana statutory law relating to such notice requirements in effect in 2006 (an applicable law became effective several months after the policy was renewed), the court ruled the existence of an Indiana appellate decision, which did not require advance notice, was sufficient to establish an actual conflict. Having concluded that a conflict of law existed, the court addressed which state's law should govern the dispute. Noting that the policyholder was an Indiana corporation and that the only connection to Illinois was that a fax was allegedly sent to an Illinois resident, the court ruled that Indiana law governed the insurance dispute. Consequently, because no advance notice was required under Indiana law, the court ruled that Cincinnati's TCPA exclusion was valid.

Privilege Alert:

New York Court of Appeals Declines to Expand Common Interest Exception to Waiver of Privilege

The New York Court of Appeals ruled that to maintain privilege under the common interest doctrine, it is not enough that the parties share a common legal interest; rather, the communication at issue must also relate to pending or anticipated litigation. *Ambac Assurance Corp. v. Countrywide Home Loans, Inc.*, 2016 WL 3188989 (N.Y. June 9, 2016).

Ambac Assurance sued Countrywide Home Loans, alleging breach of contract and fraudulent misrepresentation based on the failure of mortgage-backed securities. Ambac named Bank of America as a defendant based on its merger with Countrywide. During litigation, Ambac challenged Bank of America's withholding of several hundred communications between Bank of America and Countrywide that took place after the merger plan was signed, but before the transaction closed. Bank of America claimed that the documents were protected by attorney-client privilege because they contained legal advice relating to the merger. Bank of America further argued that, although the documents were shared with Countrywide, privilege was not waived because the parties shared a common legal interest.

A Special Referee concluded that the common interest exception to privilege waiver applied only if the parties shared a common legal interest in pending or reasonably anticipated litigation. Bank of America moved to vacate the Referee's decision on the basis that pending or anticipated litigation was not

required under the common interest doctrine. A New York trial court denied the motion. An intermediate appellate court reversed, ruling that pending or anticipated litigation was no longer a necessary element of the common interest exception under New York law. The New York Court of Appeals reversed.

In declining to expand the common interest doctrine to protect shared communications in furtherance of any common legal interest, the New York Court of Appeals stated that:

> we do not perceive a need to extend the common interest doctrine to communications made in the absence of pending or anticipated litigation, and any benefits that may attend such an expansion of the doctrine are outweighed by the substantial loss of relevant evidence, as well as the potential for abuse.

The court acknowledged that other jurisdictions have employed a less stringent standard for application of the common interest doctrine, but concluded that the policy reasons for maintaining a litigation limitation on the doctrine outweighed any purported justification for eliminating it.

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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.

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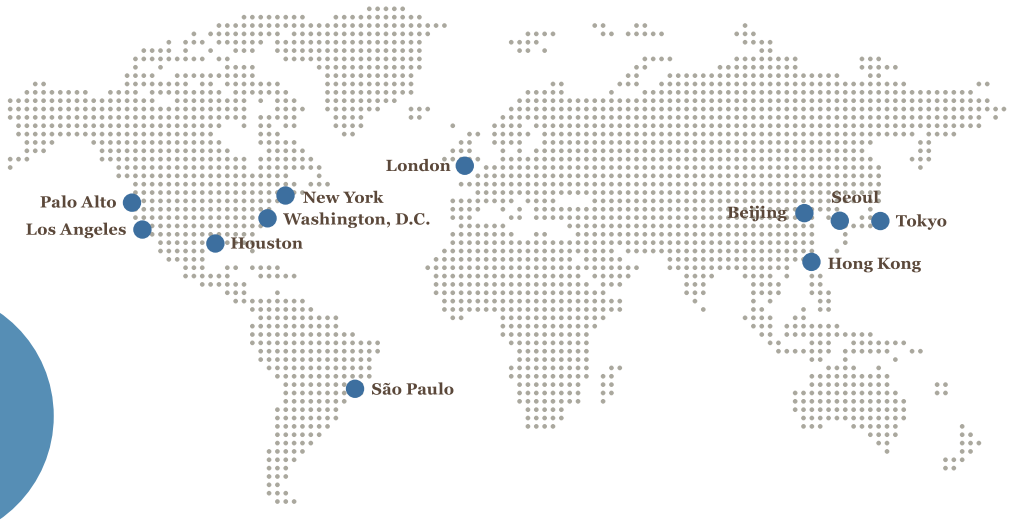

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