Simpson Thacher

Insurance Law Alert

November 2022

> "They are tremendous writers and do a great job collaborating with co-counsel. They understand and are dedicated to the industry."
>
> **– *The Legal 500* (quoting a client)**

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An Ohio district court ruled that an insured's loss of use of computer servers from a third-party vendor did not give rise to coverage under a property policy. *Computer Programming Unlimited, Inc. v. Hartford Cas. Ins. Co.,* No. 3:21-CV-2350 (N.D. Ohio Oct. 26, 2022). (Click here for full article)

Kentucky Supreme Court Rules That Government Subpoena Does Not Trigger Policy's Prior Notice Exclusion

The Kentucky Supreme Court ruled that the policyholder's tender of a government subpoena to its D&O insurer a few years before it was named as a defendant in civil litigation did not trigger a prior notice exclusion in a professional liability policy. *Ashland Hospital Corp. v. Darwin Select Ins. Co.,* 2022 WL 12198051 (Ky. Oct. 20, 2022). (Click here for full article)

Claims Based On Insurer's Alleged Disclosure Of Personal Identifying Information May Proceed, Says New York District Court

A New York district court denied in part an insurer's motion to dismiss claims stemming from the alleged disclosure of plaintiffs' personal identifying information to cybercriminals. *Rand v. Travelers Indem. Co.,* 2022 WL 15523722 (S.D.N.Y. Oct. 26, 2022). (Click here for full article)

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A Minnesota district court granted a policyholder's summary judgment motion, ruling that losses stemming from a hacking scheme that allowed a bad actor to intercept and impersonate emails relating to invoice payments were covered under a Technology Professional Liability Policy. *Fishbowl Solutions, Inc. v. Hanover Ins. Co.,* 2022 WL 16699749 (D. Minn. Nov. 3, 2022). (Click here for full article)

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Two Recent Decisions Highlight Parameters Of Broker Liability For Negligent Procurement Of Insurance

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Arizona Supreme Court Rules That Insurer May Not Depreciate Labor Costs In Calculating Actual Cash Value

The Arizona Supreme Court ruled that labor costs may not be depreciated in calculating actual cash value for property insurance purposes. *Walker v. Auto-Owners Ins. Co.,* 254 Ariz. 17 (2022). (Click here for full article)

STB News Alerts

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Coverage Alerts:

Loss Of Use Of Computer Servers Is Not Direct Physical Loss, Says Ohio District Court

An Ohio district court ruled that an insured's loss of use of computer servers from a third-party vendor did not give rise to coverage under a property policy. *Computer Programming Unlimited, Inc. v. Hartford Cas. Ins. Co.*, No. 3:21-CV-2350 (N.D. Ohio Oct. 26, 2022).

Computer Programming Unlimited ("CPU"), an information technology service provider, secured server space from Nuvolat Cloud. When Nuvolat notified CPU that it was filing for bankruptcy and unable to continue providing cloud services, CPU retained a replacement vendor and was able to transfer its client data without any interruption in service. Thereafter, CPU sought coverage from Hartford for losses allegedly incurred in connection with Nuvolat's default in services. Hartford denied coverage based on the absence of direct physical loss or damage, as required by the policy. CPU filed suit and Hartford moved for summary judgment.

The court ruled in Hartford's favor, holding that Nuvolat's inability to continue providing servers did not constitute physical loss or damage. The court explained that "loss of use, functionality, and reliability" is insufficient to establish direct physical loss or damage, and in any event, is explicitly excluded from coverage under the policy. The court distinguished cases in which a loss of use resulted from a physical alteration to covered property and was therefore deemed to be within the scope of coverage.

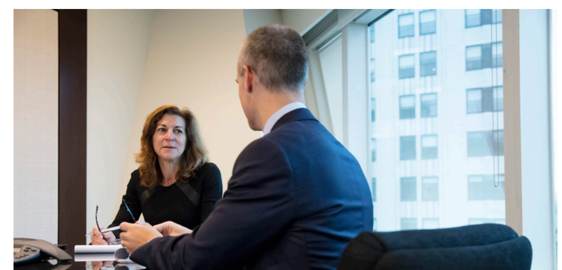
Kentucky Supreme Court Rules That Government Subpoena Does Not Trigger Policy's Prior Notice Exclusion

The Kentucky Supreme Court ruled that the policyholder's tender of a government subpoena to its D&O insurer a few years before it was named as a defendant in civil litigation did not trigger a prior notice exclusion in a professional liability policy. *Ashland Hospital Corp. v. Darwin Select Ins. Co.,* 2022 WL 12198051 (Ky. Oct. 20, 2022).

In 2011, the Department of Justice ("DOJ") served a *subpoena duces tecum* on a hospital, seeking files relating to its treatment of cardiac patients. The hospital's D&O insurer agreed to cover the costs incurred in complying with the subpoena. In 2013, the hospital notified Allied, its professional liability insurer, of the subpoena and ongoing investigation, as well as a litigation hold letter it received from counsel said to represent hundreds of potential claimants against the hospital. Allied argued that those notifications did not constitute proper "notice of circumstances that might give rise to a claim" because they failed to include certain specific details required under the policy. In addition, Allied asserted that coverage was barred by Exclusion 15, which applied to claims "based on, arising out of, directly or indirectly resulting from, or in consequence of, or in any way involving . . . any facts, matters, events, suits or demands notified or reported to, or in accordance with, any policy of insurance . . . in effect prior to October 16, 2012." Allied's position was that Exclusion 15 applied because the hospital had submitted the subpoena claim to its D&O insurer in 2011. Nonetheless, Allied agreed to defend the underlying civil suit under a reservation of rights.

The DOJ investigation ended with a settlement in which the hospital did not concede liability but agreed to pay approximately $40 million in fines. Thereafter, the hospital filed a declaratory judgment action, seeking a ruling as to its rights under Allied's policy as well as an excess policy. A trial court ruled in the hospital's favor, finding that neither Exclusion 15, nor two other exclusions (relating to intentional acts or government-related claims) barred coverage. An intermediate appellate court reversed, finding that Exclusion 15 applied.

The Kentucky Supreme Court reversed. The court held that Exclusion 15 did not apply because the subpoena did not constitute



adequate notice of circumstances giving rise to a claim in 2011. In particular, the subpoena failed to specify the "time, date and place" of the claim or "a description of the injury or damage which has allegedly resulted." The court explained that while subsequent events that unfolded over the following two years ultimately indicated that the DOJ investigation and the civil suit arose from the same facts and events, that conclusion was not evident in 2011, when the hospital notified its D&O insurer of the subpoena. The court stated:

> [H]indsight is 20/20. And looking at this case from the perspective of 2022, the DOJ inarguably was investigating facts, matters, and circumstances shared by the Cardiac Litigation. But in this instances, hindsight is obscuring the reasonable interpretation of the language by a lay reader which sensibly supports the interpretation that the policy contemplates a great deal of specificity to constitute notice of circumstances giving rise to a claim that is absent from the subpoena.

The court acknowledged that in some instances, notification might require supplementary communications within a reasonable period of time, but rejected "the proposition that notice could be gathered over multiple years." As the court emphasized, Allied itself took the position that that the 2011 subpoena did not constitute notice of circumstances that might give rise to a claim.

In addition, the court reasoned that Allied created an expectation of coverage by issuing consecutive policies in subsequent years even after learning of the ongoing DOJ investigation without informing the hospital of its position that Exclusion 15 would bar coverage under those policies.

Cyber Alerts:

Claims Based On Insurer's Alleged Disclosure Of Personal Identifying Information May Proceed, Says New York District Court

A New York district court denied in part an insurer's motion to dismiss claims stemming from the alleged disclosure of plaintiffs' personal identifying information to cybercriminals. *Rand v. Travelers Indem. Co.,* 2022 WL 15523722 (S.D.N.Y. Oct. 26, 2022).

A putative class of plaintiffs alleged that the insurance quote application on Travelers' website "is easily exploitable by non-parties" and that unauthorized users obtained sensitive personal information by improperly using the credentials of Travelers agents. Plaintiffs alleged that they spent time and resources detecting and preventing misuse of personal information and that additional costs would be incurred in the future in order to avoid identity theft or fraud. Travelers moved to dismiss the complaint on several bases, most of which the court denied.

The court rejected the contention that the plaintiffs did not allege an injury-in-fact to support Article III standing. The court explained that a loss of privacy, as well as the harm incurred in mitigating existing and future identity theft, were properly alleged injuries-in-fact, notwithstanding the absence of allegations that the personal information had actually been misused by cybercriminals. Noting that this was a "close call," the court concluded that based on the suspicious activity of the hackers, as well as the sensitive nature of the information accessed (name, address, date of birth and driver's license number), the complaint adequately pled an imminent risk of future identity theft and mitigating costs so as to constitute an injury-in-fact.

The court further ruled that the complaint alleged claims under the Driver's Privacy Protection Act, which prohibits entities from "knowingly disclosing or otherwise making available to any person or entity" personal information. The court explained that Travelers could be liable under this statute for a third-party's impermissible use of personal information based on its voluntary decision to auto-populate its quote responses online with

sensitive personal information. In so ruling, the court emphasized that two warnings had been issued by the New York State Department of Finance as to the vulnerability of this website feature.

The court also declined to dismiss negligence claims, finding that the complaint alleged a violation of a duty of care and recoverable damages. As to damages, the court emphasized that actual costs incurred in purchasing credit monitoring and identity theft services were cognizable expenses, but that various other current and future costs, including the time and effort spent addressing the potential consequences of a data breach or the mere fact of a lower credit score, were not recoverable damages.

Minnesota Court Rules That Email Hacking Scheme Losses Are Covered Under Cyber Business Interruption Provision

A Minnesota district court granted a policyholder's summary judgment motion, ruling that losses stemming from a hacking scheme that allowed a bad actor to intercept and impersonate emails relating to invoice payments were covered under a Technology Professional Liability Policy. *Fishbowl Solutions, Inc. v. Hanover Ins. Co.,* 2022 WL 16699749 (D. Minn. Nov. 3, 2022).

Fishbowl was the victim of a scheme in which a bad actor gained access to the email account of a senior accountant and impersonated her in communications with clients in order to provide new payment instructions for invoices. After discovering the fraud, Fishbowl sought coverage under a provision that stated:

> We will pay actual loss of "business income" and additional "extra expense" incurred by you during the "period of restoration" directly resulting from a "data breach" which is first discovered during the "policy period" and which results in an actual impairment or denial of service of "business operations" during the "policy period."

Hanover denied the claim on several bases, each of which was rejected by the court.

Actual Loss of Business Income: Hanover argued that there was no loss of "business income," defined as "Net Income . . . that

would have been earned or incurred if there had been no impairment or denial of 'business operations.'" Hanover claimed that business operations refer only to income-generating activities and that invoicing clients does not generate income, and that Fishbowl sought recovery of money already earned, rather than money "that would have been earned." Rejecting these contentions, the court concluded that the policy did not expressly limit business operations to income-generating activities and that the diversion of invoice payments was income that "would have been earned" (rather than income that was already earned) notwithstanding that the work for those invoices had already been performed.

Directly Resulting From Data Breach: While Hanover conceded that Fishbowl experienced a data breach, it argued that the loss did not result directly from that breach. Rather, Hanover claimed that the loss resulted from intervening causes, including the negligence of the customer that remitted payment to the bad actor without noticing warning signs about potential fraud. Noting the lack of evidence of such negligence, the court declined to find such "intervening agency" and ruled that Fishbowl's losses "would not have occurred without the bad actor accessing Ms. Williams's email and sending fraudulent communications."

Impairment of Business Operations: Hanover argued that there was no impairment or interruption of Fishbowl's business operations because it continued to conduct its normal income-generating activities even during the period of email hacking. Rejecting this assertion, the court held that the term "impairment" is sufficiently broad so as to encompass the hacker's interference with the accountant's email and does not require

a business to cease functioning entirely. The court noted that while the provision includes the word "Interruption" in its title, use of the word "impairment" within the text of the provision indicates that the policy "specifically grants coverage when a business suffers something less than a total suspension of operations."

Arbitration Alert:

Sixth Circuit Rules That Dispute Over Limitation Period In Reinsurance Contract Is Question For Arbitrator, Not Court

Affirming a Michigan district court decision, the Sixth Circuit ruled that the question of whether a three-year limitation in a reinsurance agreement precluded arbitration was a question for the arbitrator, not the court. *Alliance Health and Life Ins. Co. v. American National Ins. Co.,* 2022 WL 2903440 (6th Cir. July 22, 2022).

A reinsurance agreement between American National and Alliance Health included an arbitration provision that provided: "As a precedent to any right of action under this Agreement, if any dispute shall arise . . . with reference to the interpretation of the Agreement or [the parties'] rights with respect to any transaction involved, whether such disputes arise before or after termination of this Agreement, such dispute, upon the written request of either party, shall be submitted to three arbitrators." The agreement further stated that "[n]o arbitration may be commenced more than 3 years after the Effective Date of this Agreement." When American National rejected a reinsurance claim, Alliance Health sued in federal court. American National moved to dismiss on the ground that the dispute was subject to arbitration. In response, Alliance Health argued that because the claim was outside the agreement's three-year limit for commencing arbitration, it could proceed in court. The district court rejected this contention, ruling that the question of whether the time limit applied was for an arbitrator to decide. The Sixth Circuit affirmed.

The Sixth Circuit explained that application of the agreement's time limit "is a quintessential question of procedural arbitrability" under established case law. The court noted that parties may contract around such a presumption, but that the reinsurance agreement at issue contained no language indicating an intent to assign the time limit issue to a judge rather than an arbitration panel. Further, the court emphasized that the broad language in the arbitration clause supported its conclusion.

Allocation Alert:

Oregon Court Allocates Defense And Indemnity Costs On Pro Rata Basis

An Oregon district court ruled that defense costs must be allocated among insurers based on time on the risk and that indemnity costs must be allocated according to statutory law, which contemplates pro rata time on the risk and policy limits. *National Surety Corp. v. TIG Ins. Co.,* 2022 WL 16694733 (D. Ore. Nov. 2, 2022).

In this contribution action, National Surety sought a declaration that TIG Insurance issued general liability policies in certain years and was therefore required to pay its share of defense and indemnity costs for a mutual insured in underlying environmental pollution litigation. Oregon statutory law provides such a right to contribution and sets forth a list of factors to consider in allocation, including each insurer's time on the risk and policy limits, among other things. *See* O.R.S. 464.480(5).

The court held that the statute, which refers to allocation of "covered damages," applies only to indemnity costs, and not to defense

costs. The court further concluded that the most equitable method of allocating defense costs was time on the risk, the method endorsed by the majority of district courts in Oregon and in other jurisdictions addressing the allocation of defense costs between consecutive insurers in the context of environmental claims. In so ruling, the court noted that time on the risk allocation aligns insurers' expectations of defense costs with the proportion of risk they assumed based on the duration of their coverage period in comparison to the overall period of damage or injury.

With respect to indemnity costs, the court applied the factors set forth in O.R.S. 465.480(5) and endorsed a method that allocated costs based on the average of each insurer's pro rata time on the risk (*i.e.*, the percentage of time the policy was in effect as compared to the total period of damage) and its policy limits (*i.e.*, the percentage of the policy limit of the particular policy as compared to the overall insurance limits during the total period of damage).

Broker Alert:

Two Recent Decisions Highlight Parameters Of Broker Liability For Negligent Procurement Of Insurance

The Eighth Circuit affirmed the dismissal of negligence claims against an insurance agent, whereas a California jury concluded that an agent was professionally negligent in failing to procure insurance.

In *I Square Management, LLC v. McGriff Ins. Svs., Inc.*, 2022 WL 16828847 (8th Cir. Nov. 9, 2022), policyholders sued their insurance agent for negligence after learning that their policy did not cover flood-related losses. The policyholders alleged that their agent advised them that a builder's risk policy was unnecessary for a construction project, which resulted in the absence of coverage for damage to certain property stored in a warehouse.

Applying Arkansas law, the court explained that as a general matter, the duty is on the insured to obtain the coverage needed and that an insurance agent is under no duty to provide information about additional coverage. The court noted that while some jurisdictions have imposed a duty on the agent to advise a client of appropriate coverage where a "special relationship" exists between the parties, it concluded that Arkansas was unlikely to adopt such an exception, and if it did, would apply it very narrowly in rare situations. More specifically, the court explained that neither the insured's reliance on the agent's expertise nor the agent's representations of skill and knowledge created a special relationship, stating that "it would be the rare agent who does not hold himself out as highly skilled, and the rare insured who doesn't rely on the agent's skill in making insurance selections." The court also deemed it irrelevant that the agent engaged in a personalized pitch to the insureds, which resulted in them abandoning their prior agent and hiring the current agent. Similarly, the court was not persuaded that the agent's communications with various participants in the construction project established a special relationship, noting that the communications

were "isolated and infrequent" and that the agent's involvement in the project was tangential. Finally, the court rejected the contention that the agent voluntarily assumed a duty to ensure adequate coverage, emphasizing that a single email indicating that a builder's risk policy was unnecessary did not constitute an assumption of an additional duty of care.

In contrast, a jury awarded a policyholder more than $4 million in damages after finding that an insurance agent was professionally negligent in *Daniels v. Samrick*, No. 18 CV 001467 (Cal. Super. Ct. Oct. 17, 2022). After a fire destroyed insured property, the policyholders sued their agent for professional negligence, negligent misrepresentation and breach of fiduciary duty, alleging that the agent failed to comply with their specific requests to increase coverage limits. In support of their claims, the policyholders pointed to the agent's representations and warranties about expertise, as well as the long standing relationship and course of dealings for decades. After a three week trial, the jury found that the agent was professionally negligent and that the negligence was a substantial factor in causing harm to the policyholders. However, the jury also concluded that the policyholders were partially responsible based on their negligence in obtaining the coverage they wanted.

Property Insurance Alert:

Arizona Supreme Court Rules That Insurer May Not Depreciate Labor Costs In Calculating Actual Cash Value

As discussed in previous Alerts, several state supreme courts and federal appellate courts have addressed whether an insurer may depreciate labor costs in calculating actual cash value ("ACV"). *See* May and October 2021 Alerts; March and April 2020 Alerts; April 2019 Alert; March 2017 Alert; January and February 2016 Alerts. The Arizona Supreme Court recently weighed in, ruling that labor costs may not be depreciated in the ACV calculation. *Walker v. Auto-Owners Ins. Co.*, 254 Ariz. 17 (2022).

An Arizona district court certified two questions to the Arizona Supreme Court:

> (1) When a homeowner's insurance policy does not define the terms "actual cash value" or "depreciation," may an insurer depreciate the costs of both materials and labor in determining the actual cash value of a covered loss?
>
> (2) Is the broad evidence rule applicable in Arizona such that an insurer and/or fact finder may consider labor depreciation as a pertinent factor in determining actual cash value?

The Arizona Supreme Court answered both questions in the negative with respect to the policy at issue. The court noted that the highest courts in Illinois, Tennessee, Arkansas and Mississippi have not permitted the depreciation of labor costs in calculating ACV and emphasized that under Arizona law, an insurer seeking to limit its liability under a policy must "clearly and distinctly" do so through policy language. With respect to the broad evidence rule, the court held that while the rule was not applicable in the present case, it could potentially apply in interpreting other property policies.

STB News Alerts

Joshua Polster and Laurel Fresquez authored "Insurance Ruling Provides Lessons On Cyberattack 'Twofers,'" published by *Law360*. The article examines a recent Minnesota district court decision analyzing insurance coverage for a cyberattack involving hacking and social engineering components under two distinct policy provisions with separate limits.

Summer Craig participated in the *Practicing Law Institute*'s "Property and Casualty Insurance Law 2022" program on October 27th in New York. Summer spoke on a panel titled "Environmental Insurance: Business Interruption Coverage and Claims," which included discussion of policy provisions addressing both first-party and third-party claims. The panelists explained how to interpret business interruption coverage language in connection with "communicable disease" coverage claims; how to prepare or review potential COVID-19 claims under pollution policies; and how to evaluate coverage issues arising from PFAS, among other items.

Lynn Neuner was named a 2022 "Litigation Trailblazer" by *The National Law Journal*. Lynn was recognized for her work in ongoing litigation over a Ponzi scheme perpetrated by Robert Allen Stanford, as well as for wins secured on behalf of clients in insurance coverage litigation and securities class actions, and her longstanding advocacy on behalf of veterans.

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

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

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

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

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

Joshua Polster
+1-212-455-2266
joshua.polster@stblaw.com

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

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

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

Sarah E. Phillips
+1-212-455-2891
sarah.phillips@stblaw.com

Isaac M. Rethy
+1-212-455-3869
irethy@stblaw.com

Abigail W. Williams
+1-202-636-5569
abigail.williams@stblaw.com

This edition of the Insurance Law Alert was prepared by Bryce L. Friedman / +1-212-455-2235 bfriedman@stblaw.com and Chet A. Kronenberg / +1-310-407-7557 ckronenberg@stblaw.com with contributions by Karen Cestari kcestari@stblaw.com.

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Simpson Thacher

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

Brussels
Square de Meeus 1, Floor 7
B-1000 Brussels
Belgium
+32-472-99-42-26

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