SIMPSON THACHER

INSURANCE LAW ALERT

OCTOBER 2013

This Alert discusses a recent federal court decision halting reinsurance arbitration on the basis of potential arbitrator partiality. In addition, we summarize decisions relating to a policyholder's breach of a "no voluntary payment" provision and the scope of general liability coverage for asbestos and construction defect claims. We also report on rulings relating to coverage for Madoff-related losses, D&O coverage for government investigative measures and an insurer's right to seek contribution for defense costs from a settling insurer, among others. Please "click through" to view articles of interest.

- ***Michigan District Court Issues Preliminary Injunction Halting Reinsurance Arbitration***

  A Michigan federal district court issued a preliminary injunction to halt a reinsurance arbitration on the basis of potentially improper arbitrator conduct. *Star Ins. Co. v. National Union Fire Ins. Co.*, 2013 WL 5182745 (E.D. Mich. Sept. 12, 2013). *Click here for full article*

- ***Policyholder's Breach of "No Voluntary Payment" Clause Does Not Bar Coverage Unless Insurer Suffers Prejudice, Says Colorado Appellate Court***

  A Colorado appellate court ruled that a policyholder's violation of a "no voluntary payment" clause does not bar coverage if the insurer is not prejudiced by the violation. *Stresscon Corp. v. Travelers Prop. Cas. Co. of Am.*, 2013 WL 4874352 (Colo. App. Sept. 12, 2013). *Click here for full article*

- ***Ohio Court Issues Aggregate Limit and Number-of-Occurrences Rulings in Asbestos Litigation***

  In asbestos coverage litigation, an Ohio court addressed allocation, aggregate limits for multi-year policies and whether personal injury claims constituted a single occurrence or multiple occurrences. *William Powell Co. v. OneBeacon Ins. Co.*, No. A-1109350 (Ohio Ct. C.P. Hamilton Cnty. Sept. 12, 2013). *Click here for full article*

- ***Alabama Supreme Court Weighs in on General Liability Coverage for Construction Defect Claims***

  The Alabama Supreme Court ruled that construction defect claims did not constitute an "occurrence" because the property damage was limited to the faulty construction work itself. *Owners Ins. Co. v. Jim Carr Homebuilder, LLC*, 2013 WL 5298575 (Ala. Sept. 20, 2013). *Click here for full article*

- ***New York Court Rules That Brokerage Exclusion Does Not Apply to Madoff-Related Losses***

  A New York trial court ruled that a policy exclusion barring coverage for losses caused by the dishonest acts of brokers did not apply to Madoff-related losses because Madoff and Madoff Securities were acting as imposters rather than brokers. *U.S. Fire Ins. Co. v. Nine Thirty FEF Investments, LLC*, No. 603284/09 (N.Y. Sup. Ct. Oct. 1, 2013).
  Click here for full article

- ***New Jersey Supreme Court Upholds Insurer's Defense Cost Contribution Claim***

  The New Jersey Supreme Court ruled that an insurer is entitled to bring a direct claim for contribution of defense costs against a co-insurer in a continuous property damage case, regardless of a settlement between the co-insurer and the policyholder. *Potomac Ins. Co. of Ill. v. Pa. Mfrs.' Ass'n Ins. Co.*, 2013 WL 5018577 (N.J. Sept. 16, 2013).
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- ***Pollution Exclusion Does Not Preclude Duty to Defend Personal Injury Claims Stemming From Exposure to Toxins at World Trade Center Site, Says New York District Court***

  A federal district court in New York ruled that a pollution exclusion does not relieve insurers of their duty to defend bodily injury claims arising from exposure to toxic materials at the World Trade Center site in the aftermath of September 11, 2001. *120 Greenwich Dev. Assocs., L.L.C. v. Admiral Indem. Co.*, No. 08 Civ. 6491 (LAP) (S.D.N.Y. Sept. 25, 2013). *Click here for full article*

- ***Virginia Court Rules That Investigative Measures Trigger D&O Coverage***

  A Virginia federal district court ruled that the issuance of a search warrant and subpoena and written notice of investigation from the government satisfied the policy's "claim" requirement. *Protection Strategies, Inc. v. Starr Indem. & Liab. Co.*, No. 1:13-CV-00763 (E.D. Va. Sept. 10, 2013). *Click here for full article*

- ***New York District Court Rules That Destruction of ESI Warrants Adverse Jury Instruction***

  A New York federal district court issued an adverse jury instruction and imposed costs in light of a party's willful destruction of electronically stored information. *Sekisui American Corp. v. Hart*, 2013 WL 4116322 (S.D.N.Y. Aug. 15, 2013). *Click here for full article*

ARBITRATION ALERT:

Michigan District Court Issues Preliminary Injunction Halting Reinsurance Arbitration

Previous Alerts have discussed decisions addressing the circumstances under which courts will intervene in ongoing arbitrations on the basis of arbitrator partiality. *See* December 2010 Alert, February and March 2011 Alerts, March 2012 Alert, June 2013 Alert. In a decision that runs counter to the emerging trend of judicial restraint in this context, a Michigan federal district court issued a preliminary injunction to halt a reinsurance arbitration on the basis of potentially improper arbitrator conduct. *Star Ins. Co. v. National Union Fire Ins. Co.*, 2013 WL 5182745 (E.D. Mich. Sept. 12, 2013).

The reinsurance dispute arose from a treaty between National Union and a group of ceding insurers (the "Plaintiffs"). An arbitration provision required all disputes to be decided by a panel of three arbitrators. Each party was entitled to select its own arbitrator, who together would choose an umpire. The two party-selected arbitrators were unable to agree on an umpire, and thus "cast[ ] lots" in order to choose the umpire, who disclosed a close friendship with National Union's arbitrator. Following a hearing, the panel issued an interim award addressing liability, leaving the issue of damages to be resolved in further proceedings. Following the interim award, documents submitted by National Union in support of a claim for attorneys' fees indicated that counsel for National Union had several *ex parte* communications with its appointed arbitrator after the interim award had been issued. In addition, Plaintiffs learned that several National Union employees and National Union's counsel sat on a panel together for an insurance seminar (which was funded by the counsel's law firm) with the arbitrator and had scheduled panel discussions during the course of arbitration. Finally, the record

established that National Union's arbitrator and the umpire issued two orders in the arbitration with respect to which Plaintiffs' appointed arbitrator received email communications but as to which he asserted he was denied an opportunity to provide substantive input. In light of these events, Plaintiffs moved to vacate or modify the award, and/or stay proceedings. When a majority of the panel denied these motions, Plaintiffs sought injunctive relief in federal court. A Michigan federal district court granted the motion.

The court stated that the issuance of a preliminary injunction to stay arbitration turns on the following factors: (1) the moving party's likelihood of success on the merits; (2) irreparable harm if the relief is not granted; (3) the possibility of substantial harm to others; and (4) public interest impact. Here, the court concluded that Plaintiffs were likely to succeed on the merits in their motion to stay arbitration until the nature of the relationship between National Union's counsel and its party-appointed arbitrator could be investigated. The

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court reasoned that the *ex parte* communications with the arbitrator, together with the joint participation of National Union's counsel and employees on an insurance panel that included National Union's appointed arbitrator, "call into question whether the true nature of the relationship between the two was hidden." The court held that Plaintiffs were also likely to succeed on the basis that the arbitration panel violated the contractual provision requiring three arbitrators to deliberate over disputed issues. As to the other preliminary injunction factors, the court found credible Plaintiffs' position that Plaintiffs would suffer harm to good will and standing in the insurance community in light of a potential adverse $25 million award in the arbitration. The court also opined that National Union would not suffer irreparable harm if arbitration was stayed and that public policy favored ensuring the integrity of the arbitration process.

Star Insurance is an example of the rare case in which a court will interfere with an ongoing arbitration and exercise jurisdiction over matters subject to arbitration prior to the issuance of a final award. In rejecting National Union's jurisdictional challenge, the court noted that under the Federal Arbitration Act, a court may intervene in ongoing arbitration if the agreement is "subject to attack under general contract principles," as the court determined was the case here. It remains to be seen whether the district court's decision will withstand appellate scrutiny.

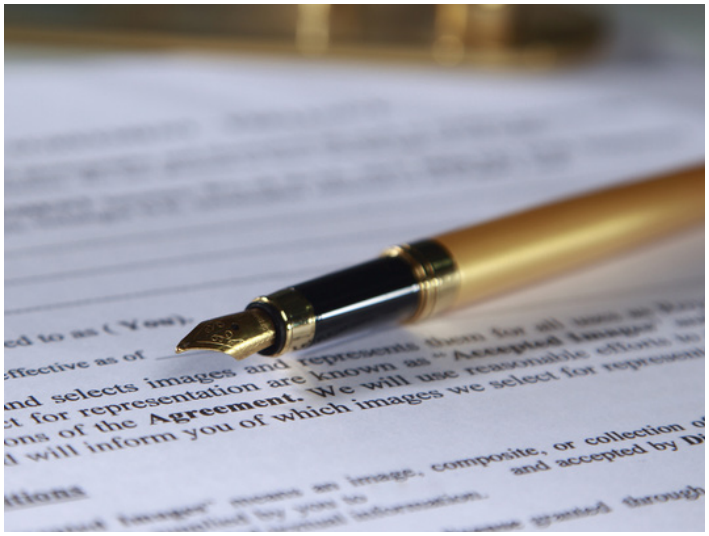
Voluntary Payment Alert:

Policyholder's Breach of "No Voluntary Payment" Clause Does Not Bar Coverage Unless Insurer Suffers Prejudice, Says Colorado Appellate Court

Our September 2013 Alert discussed a Texas Supreme Court decision holding that an insurer was required to pay for a policyholder's voluntary payments despite a failure to obtain insurer consent. *See Lennar Corp. v. Markel Am. Ins. Co.*, 2013 WL 4492800 (Tex. Aug. 23, 2013). Last month, a Colorado appellate court followed suit, ruling that a policyholder's violation of a "no voluntary payment" clause does not bar coverage if the insurer is not prejudiced by the violation. *Stresscon Corp. v. Travelers Prop. Cas. Co. of Am.*, 2013 WL 4874352 (Colo. App. Sept. 12, 2013).

Following a construction accident, the general contractor sought from a concrete company damages stemming from the resulting delay in the project. When the concrete company notified its insurer of the claim, the insurer issued a reservation of rights. Thereafter, the concrete company settled with the contractor, making a lump sum payment that represented both delay damages and other damages related to the accident. The concrete company did not obtain consent from its insurer prior to the settlement. Months later, the concrete company sued its insurer seeking indemnification for the delay damages portion of the settlement. According to the Colorado appellate court decision, the lawsuit was the first time that the insurer learned of the settlement. A jury found that the insurer had unreasonably denied coverage and granted the concrete company damages it deemed covered by the policy. The decision does not explain what facts gave rise to the jury's unreasonable denial of coverage finding. The jury further found that the insurer had not been prejudiced by the settlement. Both sides appealed on numerous bases.

A central issue on appeal was whether the concrete company's breach of the "no voluntary payment" provision resulted in an automatic forfeiture of coverage. The appellate court held that it did not. The court held that the "notice-prejudice" rule, which governs late notice defenses in Colorado, applies to violations of "no voluntary payment" provisions. Under the notice-prejudice rule, a settlement made without the insurer's consent gives rise to a presumption of prejudice. However, a policyholder may rebut that presumption, thereby shifting the burden to the insurer to establish actual prejudice by a preponderance of evidence.



Applying this standard to the record presented, the appellate court concluded that there was sufficient evidence to support the jury's finding that the insurer did not suffer prejudice and that the trial court did not err in refusing to find prejudice as a matter of law. In reaching its decision, the appellate court declined to adopt a bright line rule under which prejudice is established as a matter of law when the policyholder enters into a settlement prior to the initiation of litigation or when the settlement is "unallocated," as was the case here. However, the court did not rule out the possibility of finding prejudice as a matter of law in some cases, noting that such a finding would be warranted where a "loss of evidence . . . deprives an insurer of an opportunity to investigate defenses, to 'participate in remedial efforts, and to investigate possible claims against third parties.'"

Although *Stresscon* purports to endorse a clear legal standard, the decision may raise more questions than it answers. Litigants are likely to dispute the type of evidence necessary to overcome the prejudice presumption and/or to establish actual prejudice. Additionally, insurers may seek to limit the decision to circumstances in which the insurer is found to have unreasonably denied benefits. The *Stresscon* decision has not yet been released for publication, as a petition for rehearing or *certiorari* may be pending. As discussed in our February 2013 Alert, numerous other courts have held that a violation of a "no voluntary payment" clause bars coverage regardless of prejudice, and as noted in our July/August 2013 Alert, a Pennsylvania appellate court recently ruled that a defending insurer's duty to indemnify an underlying settlement turns on whether the insurer acted in bad faith in rejecting settlement offers where the insured accepts the insurer's defense. *Babcock & Wilcox Co. v. American Nuclear Insurers*, 2013 WL 3456969 (Pa. Super. Ct. July 10, 2013).

Coverage Alerts:

Ohio Court Issues Aggregate Limit and Number-of-Occurrences Rulings in Asbestos Litigation

In this asbestos-related insurance litigation, the court addressed three significant coverage issues: (1) whether the aggregate liability limit in three-year policies applied annually or for the full policy term; (2) what constitutes an "occurrence" in the context of asbestos claims; and (3) whether the insured can direct the method of allocation. *William Powell Co. v. OneBeacon Ins. Co.*, No. A-1109350 (Ohio Ct. C.P. Hamilton Cnty. Sept. 12, 2013).

Aggregate Limits: The court concluded that for all applicable three-year policies, the aggregate limit

applied annually rather than for the entire policy period. Policies issued after 1965 contained express language stating that the limits applied annually. However, no such language was included in the pre-1965 policies, many of which were missing or incomplete. The court concluded that for these three-year policies, the term "aggregate" was ambiguous. Having found ambiguity, the court considered extrinsic evidence, including the parties' course of conduct and the premium amounts before and after 1965. The court concluded that the factual record was consistent with annual limits. In so ruling, the court rejected the notion that the addition of specific annual limit language post-1965 demonstrated that the parties did not intend the earlier policies to contain annual aggregate limits.

Number of Occurrences: The court held that under all policies, each individual claimant's exposure to asbestos constituted a separate occurrence. Policies issued prior to 1968 did not define the term "occurrence." Post-1968 policies defined "occurrence" as "an accident, including exposure to conditions, which results, during the policy period, in bodily injury or property damage neither expected nor intended from the standpoint of the insured." After 1975, the language changed to "an accident, including continuous or repeated exposure to conditions." Citing to Ohio case law, the court held that under all policies, each individual claimant's exposure to asbestos constituted a separate occurrence. The court rejected the argument that the policyholder's unitary decision to manufacture/sell asbestos-containing products constituted a single occurrence.

Allocation: The court declined to rule on allocation as a matter of law, leaving open the possibility of pro rata allocation despite Ohio's endorsement of "all sums" allocation. Although the majority of jurisdictions endorse pro rata allocation where injury spans multiple policy periods, Ohio has adopted an "all sums" approach under which a policyholder is entitled to select coverage from a single policy, subject to that policy's coverage limits. Here, however, the parties had been operating under a pro rata approach prior to the litigation. As such, the insurer argued that the

policyholder should be precluded from seeking "all sums" from one insurer. The court declined to rule as a matter of law, finding that disputed questions of fact existed on this issue. The court's refusal to grant the policyholder's summary judgment motion on this issue illustrates the relevance of the parties' course of conduct to allocation matters.

Alabama Supreme Court Weighs in on General Liability Coverage for Construction Defect Claims

Previous Alerts have highlighted decisions addressing whether faulty workmanship claims constitute a covered "occurrence." *See* April 2010 Alert, May 2013 Alert. Courts have employed various approaches, focusing on myriad factors, including whether property damage was foreseeable or expected and whether the damage was limited to the defective work itself or extended to other non-defective property. In a recent decision, the Alabama Supreme Court focused on the latter element, ruling that construction defect claims did not constitute an "occurrence" because the property damage was limited to the faulty construction work itself. *Owners Ins. Co. v. Jim Carr*

Homebuilder, LLC, 2013 WL 5298575 (Ala. Sept. 20, 2013).

After discovering defects in the construction of their new home, homeowners sued their builder for breach of contract, fraud and negligence. The dispute was ultimately resolved through arbitration, with a final award issued in favor of the homeowners. The builder's insurer denied coverage for the damages, arguing that the underlying claims did not give rise to a covered "occurrence." The trial court disagreed, ruling that the policy covered the arbitration award. The Alabama Supreme Court reversed.

The Alabama Supreme Court set forth the following rule of law:

> [F]aulty workmanship performed as part of a construction or repair project may lead to an occurrence if that faulty workmanship subjects personal property or other parts of the structure *outside the scope of that construction or repair project* "to 'continuous or repeated exposure' to some other 'general harmful condition'" and if, as a result of that exposure, that personal property or other *unrelated* parts of the structure are damaged.

Applying this standard, the court concluded that there was no occurrence because the builder contracted to build the entire house and there was no damage to property other than the house itself.

New York Court Rules That Brokerage Exclusion Does Not Apply to Madoff-Related Losses

Previous Alerts have summarized decisions denying insurance coverage for false profits lost in connection with Bernard Madoff's Ponzi scheme. *See* November 2010 Alert, July/August 2011 Alert, February 2013 Alert. These decisions were based, in part, on the notion that the loss of fictitious or phantom profits are not actual "losses." In a related context, a New York trial court recently ruled that a policy exclusion barring coverage for losses caused by the dishonest acts of brokers did not apply to Madoff-related losses because Madoff and Madoff Securities were not acting as brokers but "were actually imposters who merely pretended to be or do something as part of their fraudulent scheme." *U.S. Fire Ins. Co. v. Nine Thirty FEF Investments, LLC*, No. 603284/09 (N.Y. Sup. Ct. Oct. 1, 2013).

Two investment companies sought coverage for Madoff-related losses under financial bonds issued by U.S. Fire Insurance Company. U.S. Fire denied coverage on the basis of a policy exclusion that precluded coverage for "loss resulting directly or indirectly from any dishonest or fraudulent act or acts committed by any non-Employee who is a securities, commodities, money, mortgage, real estate, loan, insurance, property management, investment banking broker, agent or other representative of the same general character." The court found the exclusion inapplicable. As a preliminary matter, the court held that Madoff's status as a registered broker did not, without more, trigger the broker exclusion so as to automatically bar coverage. Instead, the court held that in order for the exclusion to apply, Madoff must have been "acting" as a securities broker in connection with the losses. The court concluded that he was not. The court cited evidence

that Madoff engaged in only illusory brokerage activities and that brokerage statements contained fictitious trades rather than genuine transactions. The court observed that "Madoff and Madoff Securities were not rogue brokers churning brokerage accounts to generate exorbitant fees; he was doing nothing more than running an elaborate confidence game—he was a con man."

Contribution Alert:

New Jersey Supreme Court Upholds Insurer's Defense Cost Contribution Claim

Addressing a novel issue of law, the New Jersey Supreme Court ruled that an insurer is entitled to bring a direct claim for contribution of defense costs against a co-insurer in a continuous property damage case, regardless of a settlement between the co-insurer and the policyholder. *Potomac Ins. Co. of Ill. v. Pa. Mfrs.' Ass'n Ins. Co.*, 2013 WL 5018577 (N.J. Sept. 16, 2013).

The insurance coverage dispute arose out of construction defect claims against the policyholder. The policyholder was insured under general liability policies issued by several insurers, including Pennsylvania Manufacturers' Insurance Company ("PMA") and OneBeacon Insurance Company. OneBeacon defended the policyholder in the underlying action, whereas PMA disclaimed coverage. Ultimately, the policyholder settled with PMA, releasing the insurer from all defense and indemnity claims in exchange for PMA's $150,000 contribution to the settlement of the underlying action. Following that settlement, OneBeacon sought contribution of defense costs from PMA. PMA refused to contribute, arguing that the release it obtained from the policyholder barred OneBeacon's contribution claim. In ensuing litigation, a New Jersey trial court ruled that OneBeacon's contribution claim was valid, and awarded the insurer a percentage of defense costs from PMA. The appellate court affirmed in relevant part, *Potomac Ins. Co. of Ill. v. Pa. Mfrs.' Ass'n Ins. Co.*, 2012 WL 1231841 (N.J. Super. Ct. App. Div. Apr. 13, 2012) (*see* May 2012 Alert), and the New Jersey Supreme Court affirmed the appellate court decision.

The New Jersey Supreme Court held that, under New Jersey law, "an insurer may assert, against a co-insurer, a claim for defense costs incurred in litigation arising from property damage manifested over a period of several years, during which the policyholder is insured by successive carriers." The court observed that contribution claims among insurers comport with New Jersey's endorsement of "continuous trigger" and pro rata allocation for ongoing property damage claims. In particular, the court noted that when multiple insurance policies are implicated by a continuous trigger, contribution claims between co-insurers ensure equitable allocation of the policyholder's losses. The court further noted that allowing defense cost contribution claims "creates a strong incentive for prompt and proactive involvement by all responsible carriers" and promotes efficiency and early settlement. Finally, the court explained that the policyholder's release of claims against PMA did not operate to

extinguish OneBeacon's contribution claim against PMA because OneBeacon was not a party to that settlement agreement.

Courts across jurisdictions have both allowed and rejected contribution claims against co-insurers. Decisions in this context frequently turn on several factors, including whether the claim is based on principles of subrogation or of equitable contribution and/or whether payment is sought for defense or indemnity costs. *See* April and June 2010 Alerts, May, July/August and November 2011 Alerts.

Pollution Exclusion Alert:

Pollution Exclusion Does Not Preclude Duty to Defend Personal Injury Claims Stemming From Exposure to Toxins at World Trade Center Site, Says New York District Court

A federal district court in New York ruled that a pollution exclusion does not relieve insurers of their duty to defend bodily injury claims arising from exposure to toxic materials at the World Trade Center site in the aftermath of September 11, 2001. *120 Greenwich Dev. Assocs., L.L.C. v. Admiral Indem. Co.*, No. 08 Civ. 6491 (LAP) (S.D.N.Y. Sept. 25, 2013).

Following the September 11 terrorist attack, thousands of lawsuits were filed seeking compensation for alleged injuries arising out of exposure to harmful elements in and around the World Trade Center site. The lawsuits alleged that defendants caused these injuries by "failing to provide adequate protective equipment and otherwise assure the safety of, or warn about the dangers of, the plaintiffs' workplace, which contained an array of hazardous chemicals released as a consequence of the terrorist attacks." The complaints, which allege exposure to fiberglass, glass, silica, asbestos, lead and benzene, assert, among other things, common law negligence and violations of state and federal labor laws. Greenwich, a defendant in numerous actions, sought a defense from its commercial liability carriers, including Admiral Indemnity Company. Admiral declined to defend, citing the policy's pollution exclusion, which barred coverage for bodily injury arising out of the "actual, alleged or threatened discharge, dispersal, seepage,

migration, release or escape" of pollutants. Greenwich brought suit seeking to enforce Admiral's alleged defense obligations and moved for judgment on the pleadings. The court granted the motion, holding that Admiral was required to defend all claims asserted against Greenwich in the underlying litigation.

In declining to find that the pollution exclusion negated a duty to defend, the court focused on the type of claims asserted against Greenwich, rather than the cause of injury to the underlying claimants. Although the toxins that allegedly caused the claimants' injuries were undeniably pollutants, the court explained that the claims against Greenwich sound in labor law violations and negligence, rather than allegations of injury caused by exposure to pollutants. More specifically, the court reasoned that because at least some of the claims were made pursuant to labor

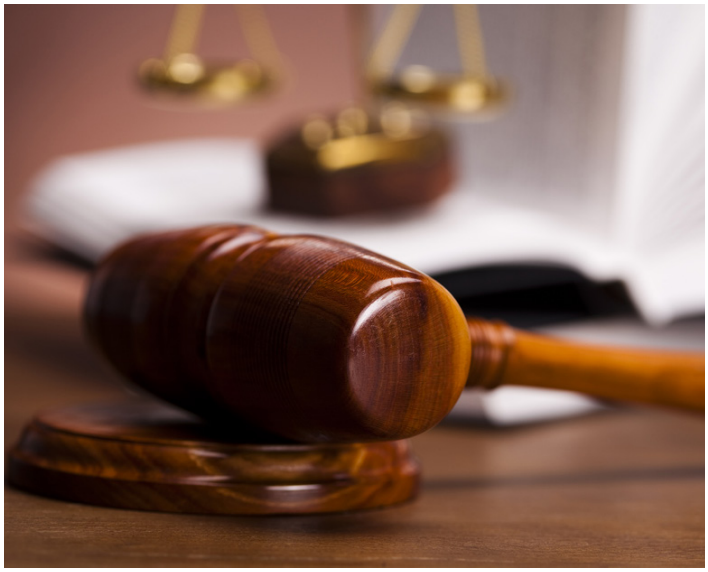
laws and were based on allegations of wrongful exposure and failure to protect (rather than allegations of actual, active polluting), Admiral failed to demonstrate that all claims were within the scope of the pollution exclusion. In its decision, the court relied on a previous World Trade Center decision involving nearly identical policy language and arguments. *See WTC Captive Ins. Co. v. Liberty Mutual Fire Ins. Co.*, 549 F. Supp. 2d 555 (S.D.N.Y. 2008).

In contrast, courts in other jurisdictions have reasoned that regardless of the theories or labels of liability, where the underlying claims inherently involve or relate to pollution, or where the claims would not have arisen "but for" pollution, the pollution exclusion applies. *See Lodwick, L.L.C. v. Chevron U.S.A., Inc.*, 2013 WL 5477240 (La. Ct. App. Oct. 2, 2013) (pollution exclusion applies to breach of contract and trespass causes of action, even if they do not explicitly allege polluting); *National Union Fire Ins. Co. v. U.S. Liquids, Inc.*, 2004 WL 304084 (5th Cir. Feb. 2004) (pollution exclusion bars coverage for securities fraud and breach of fiduciary duty claims that stem from pollution activities); *Nationwide Mutual Ins. Co. v. Lang Mgmt., Inc.*, 2010 WL 3958654 (S.D. Fla. Oct. 7, 2010) (pollution exclusion bars coverage for negligent hiring and supervision claims that arose out of pollution).

Directors and Officers Alert:

Virginia Court Rules That Investigative Measures Trigger D&O Coverage

Because D&O policies typically provide coverage for losses incurred due to "claims" against the policyholder, D&O coverage litigation often involves interpreting the scope of the term "claim." In a recent decision, a Virginia federal district court ruled that the issuance of a search warrant and subpoena and written notice of investigation from the government satisfied the policy's "claim" requirement. *Protection Strategies, Inc. v. Starr Indem. & Liab. Co.*, No. 1:13-CV-00763 (E.D. Va. Sept. 10, 2013). The policy defined "claim" as any "written demand for monetary, non-monetary, or injunctive relief made against an Insured" or any "judicial, administrative, or regulatory proceeding, whether civil or criminal, for monetary, non-monetary or injunctive relief commenced against an Insured." The court reasoned that the search warrant was a written order demanding non-monetary relief in the form of the policyholder's obligation to produce



evidence. Similarly, the court held that both the warrant and the subpoena were "the result of legal proceedings that required a finding of probable cause, leaving no question that the government had identified [the policyholder] as a target for criminal and civil liability."

Whether an agency's investigative actions constitute a covered "claim" turns primarily on applicable policy language. *Compare MBIA, Inc. v. Federal Ins. Co.*, 652 F.3d 152 (2d Cir. 2011) (subpoenas and SEC investigative order constitute "Securities Claims" under policy), with *Employers Fire Ins. Co. v. ProMedica Health Sys., Inc.*, 2013 WL 1798978 (6th Cir. Apr. 30, 2013) (various investigative measures taken by FTC do not constitute a "claim") (discussed in May 2013 Alert).

DISCOVERY ALERT:

New York District Court Rules That Destruction of ESI Warrants Adverse Jury Instruction

Reversing a magistrate judge's order, a New York federal district court issued an adverse jury instruction and imposed costs in light of a party's willful destruction of electronically stored information ("ESI"). *Sekisui American Corp. v. Hart*, 2013 WL 4116322 (S.D.N.Y. Aug. 15, 2013).

The lawsuit arose out of the acquisition of America Diagnostica Inc. ("ADI") by Sekisui American Corp. Sekisui suspected that Richard Hart, the president of ADI, had made misrepresentations in connection with the purchase documents, and therefore fired Hart and issued a notice of claim to Hart stating an intent to sue. Approximately eighteen months later, Sekisui filed a complaint alleging that Hart breached the sale contract. After litigation began, Sekisui revealed that Hart's email files had been deleted approximately five months after the notice of claim was sent. Sekisui also conceded that a litigation hold had not been implemented until about fifteen months after it issued the notice of claim. Furthermore, Sekisui did not notify its information management vendor of the duty to preserve documents until three months after it filed the complaint against Hart. During this time frame, Hart's email folder was permanently deleted, as was the ESI of another ADI employee. A federal magistrate judge concluded that although Sekisui's conduct might constitute gross negligence, sanctions were not warranted because Hart failed to establish prejudice as a result of the ESI destruction. Applying a "clearly erroneous" standard of review, a New York federal district court reversed.

The district court concluded that an adverse jury instruction was warranted because the following factors were met: (1) the party having control over the evidence had an obligation to preserve it at the time it was destroyed; (2) the evidence was destroyed with a culpable state of mind; and (3) the destroyed evidence was relevant to a party's claim or defense. Noting that Sekisui failed to "meet even the most basic document preservation obligations," the court held that Sekisui destroyed information intentionally or with gross negligence during a time in which it was required to preserve such material. The court noted that a showing of malice is not required and that, even where a good faith explanation for the destruction is offered (in this case, allegedly to save space on the company server), the destruction may be deemed willful. As to relevance, the court held that the destroyed ESI related directly to the breach of contract claim. Finally, the court held that where evidence is intentionally destroyed, prejudice may be presumed because "such destruction is sufficient evidence from which to conclude that the missing evidence was unfavorable to that party." However, the court emphasized that the presumption of prejudice applies only to the determination of whether an adverse inference jury instruction should be given; the jury was still free to determine that Hart was not prejudiced by the ESI destruction and/or to decline to draw an adverse inference based on the ESI destruction.

In a recent decision, the Third Circuit likewise allowed an adverse inference jury instruction on the basis of evidence spoliation. *See* April 2013 Alert.

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