Simpson Thacher

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–Legal 500 US 2014

New York Appellate Court Rules That Dishonest Acts Exclusion Does Not Bar Coverage for SEC Settlement Payments

A New York appellate court ruled that a Dishonest Acts Exclusion did not bar coverage for settlement payments made by Bear Stearns to the Securities and Exchange Commission because guilt had not been established by final adjudication or judgment. *J.P. Morgan Sec. Inc. v. Vigilant Ins. Co.*, 2015 WL 175512 (N.Y. App. Div. 1st Dep't Jan. 15, 2015). (click here for full article)

Eleventh Circuit Rules That "Insured v. Insured" Exclusion is Ambiguous in Context of FDIC Claims

The Eleventh Circuit ruled that an "insured v. insured" exclusion was ambiguous as applied to claims brought by the Federal Deposit Insurance Corporation as receiver for a defunct bank. *St. Paul Mercury Ins. Co. v. Fed. Deposit Ins. Corp.*, 2014 WL 7172472 (11th Cir. Dec. 17, 2014). (click here for full article)

Two Courts Address When a Claim is Made for Purposes of Coverage Under Claims-Made Policies

A Massachusetts federal district court and the Eighth Circuit both ruled that there was no coverage under a claims-made policy because the claims at issue were made prior to the inception of the policy periods. *BioChemics, Inc. v. Axis Reinsurance Co.*, 2015 WL 71493 (D. Mass. Jan. 6, 2015); *Philadelphia Consol. Holding Corp. v. LSI-Lowery Sys., Inc.*, 2015 WL 127368 (8th Cir. Jan. 9, 2015). (click here for full article)

Fifth Circuit Affirms That Misappropriation and Unfair Competition Claims Do Not Allege Personal and Advertising Injury

The Fifth Circuit ruled that a general liability insurer had no duty to defend or indemnify misappropriation and unfair competition claims against a policyholder. *Nationwide Mut. Ins. Co. v. Gum Tree Prop. Mgmt., L.L.C.*, 2015 WL 170244 (5th Cir. Jan. 14, 2015). (click here for full article)

Florida Court Rules That Statutory Violation Exclusion Bars Coverage for Conversion Claim

A Florida federal district court ruled that an insurer had no duty to defend a suit alleging statutory and common law conversion claims because a Violation of Statutes exclusion barred coverage for both claims. *Am. Cas. Co. of Reading, Pa. v. Superior Pharmacy, LLC*, No. 8:13-cv-622 (M.D. Fla. Jan. 8, 2015). (click here for full article)

Courts Reach Conflicting Conclusions as to Whether an Insurer Waived Privilege by Putting Advice of Counsel At Issue

In two recent decisions, the Arizona Court of Appeals and the Tenth Circuit reached different conclusions as to whether an insurer waived attorney-client privilege by putting the advice of counsel at issue. *Everest Indem. Ins. Co. v. Rea*, 2015 WL 195450 (Ariz. Ct. App. Jan. 15, 2015); *Seneca Ins. Co. v. Western Claims, Inc.*, 2014 WL 724071 (10th Cir. Dec. 22, 2014). (click here for full article)

Pollution Exclusion Alert:

In Back-to-Back Rulings, Wisconsin Supreme Court Holds That Pollution Exclusion Bars Coverage for Fertilizer Contamination

In *Preisler v. Gen. Cas. Ins. Co.*, 2014 WL 7373070 (Wis. Dec. 30, 2014), a septic service company sought general liability coverage for claims alleging that its negligent application of septic waste for fertilization purposes harmed a dairy farm. The insurers denied coverage on the basis of pollution exclusions that precluded coverage for harm "arising out of the actual, alleged, or threatened discharge, dispersal, seepage, migration, release or escape of 'pollutants.'" The septic company did not dispute that the septic material was dispersed onto the farmland, but argued that that material was not a "pollutant" because it had been used as fertilizer. A trial court disagreed, and ruled in favor of the insurers. An appellate court and the Wisconsin Supreme Court affirmed.

The decision is significant in several respects. First, the Wisconsin Supreme Court ruled that in construing whether a substance is a pollutant, the court must evaluate the substance "at the point it harms the interests of another" rather than "on an initial event that may have involved a beneficial use of the substance." The court therefore deemed it irrelevant that the septic waste had been applied for fertilization. Second, in concluding that a reasonable insured would consider decomposing septage as a pollutant when it seeps into a water supply, the court noted that septage handling is regulated by the Environmental Protection Agency. As discussed in our December 2013 Alert, courts disagree as to whether federal or state classifications of material should factor into a pollution exclusion analysis. Third, the court distinguished cases in which a harm-causing substance (such as carbon dioxide) was not deemed a "pollutant" because it is "universally present and generally harmless in all but the most unusual circumstances." The court noted that although individual components of septage are common, decomposing septage can release high levels of nitrates, which are not considered "generally harmless" or "pervasive."

On the same day, the Wisconsin Supreme Court employed similar reasoning and issued a second opinion addressing the pollution exclusion, holding that it unambiguously applied to claims alleging well water contamination caused by the use of cow manure as fertilizer. *Wilson Mut. Ins. Co. v. Falk*, 2014 WL 7375656 (Wis. Dec. 30, 2014). The court reasoned that although farmers may consider manure to be a "universally present, desirable and generally harmless substance," a reasonable insured would consider manure in a well to be a pollutant. The court noted that the pollution exclusion analysis focuses on the occurrence that caused property damage–*i.e.*, the seepage of the manure and resultant contamination of neighboring wells–not on the initial application of the manure.

D&O Alerts:

New York Appellate Court Rules That Dishonest Acts Exclusion Does Not Bar Coverage for SEC Settlement Payments

Our March 2014 Alert reported on a New York trial court decision holding that a Dishonest Acts Exclusion did not bar coverage for settlement payments made by Bear Stearns to the Securities and Exchange Commission because guilt had not been established by final adjudication or judgment. *J.P. Morgan Sec. Inc. v. Vigilant Ins. Co.*, 2014 WL 804129 (N.Y. Sup. Ct. New York Cnty. Feb. 28, 2014). This month, an appellate court affirmed the ruling. *J.P. Morgan Sec. Inc. v. Vigilant Ins.*

Co., 2015 WL 175512 (N.Y. App. Div. 1st Dep't Jan. 15, 2015).

The Dishonest Acts Exclusion at issue barred coverage for claims arising out of any "deliberate, dishonest, fraudulent or criminal act or omission," but only if a "judgment or other final adjudication" in the underlying case established such guilt. The appellate court ruled that the exclusion did not apply where the underlying claims were resolved by settlement and administrative order, which are not equivalent to a final adjudication, notwithstanding the incorporation of certain adverse "findings" in the order. The appellate court explained that the settlement did not "establish" Bear Stearns' guilt, noting the company's refusal to admit guilt and its express reservation to contest findings in unrelated proceedings. The appellate court distinguished decisions in which New York courts ruled that a consent decree established that a policyholder's payments constituted uninsurable disgorgement, stating that the present case is "strictly concerned with the unrelated issue of whether an exclusion for 'adjudicated' wrongdoing applies where the purported 'adjudication' is a consent decree or other settlement agreement entered into by the insured, with the caveat that it is not admitting guilt other than for the purposes of the settlement."

However, the appellate court reversed the portion of the trial court decision that dismissed the insurers' affirmative defense based on the public policy against permitting insurance coverage for intentional wrongdoing. The appellate court ruled that although the absence of an "adjudication" precluded application of the Dishonest Acts exclusion, there is no adjudication requirement for an affirmative defense based on public policy grounds. The insurers were therefore entitled to rely on findings set forth in the settlement order to support a public policy-based defense.

Eleventh Circuit Rules That "Insured v. Insured" Exclusion is Ambiguous in Context of FDIC Claims

As reported in previous Alerts (*see* October and April 2014 Alerts), courts have issued conflicting decisions as to whether an "insured v. insured" exclusion in a directors and officers policy applies to claims brought

by the Federal Deposit Insurance Corporation ("FDIC") as receiver for a defunct bank. The Eleventh Circuit recently weighed in on the issue, reversing a Georgia district court and finding that the exclusion is ambiguous in this context. *St. Paul Mercury Ins. Co. v. Fed. Deposit Ins. Corp.*, 2014 WL 7172472 (11th Cir. Dec. 17, 2014).

St. Paul sought a declaration that it owed no duty to indemnify claims brought by the FDIC as receiver for a closed bank alleging tortious conduct on the part of the bank's former officers. A Georgia district court granted St. Paul's summary judgment motion, finding that the insured v. insured exclusion unambiguously barred coverage for claims brought by the FDIC. The district court reasoned that not applying the exclusion would have the effect of reading the phrase "on behalf of any Insured" out of the policy because "[a]side from a derivative action, the only party that could bring an action on a federally insured bank's behalf is the FDIC."

In reversing the district court, the Eleventh Circuit noted that Georgia law sets a "low threshold for establishing ambiguity in an insurance policy." On this basis, the Eleventh Circuit ruled that the exclusion was susceptible to two reasonable interpretations. The Eleventh Circuit relied primarily on the existence of conflicting court decisions on the issue, finding that "the most compelling argument is that courts who have addressed similarly worded insured v. insured exclusions have reached different results." The court remanded the matter for consideration of extrinsic evidence to determine the parties' intent.

Coverage Alerts:

Two Courts Address When a Claim is Made for Purposes of Coverage Under Claims-Made Policies

Two courts recently addressed the question of when a claim is first "made" or "filed" for purposes of coverage under a claims-made policy, and both concluded that there was no coverage because the claims at issue were made prior to the inception of the policy periods.

A Massachusetts federal district court ruled that an insurer had no duty to defend a Securities and Exchange Commission ("SEC") Enforcement Action and related subpoenas because the investigation was all part of a single "claim" that was first made prior to the issuance of the policy. *BioChemics, Inc. v. Axis Reinsurance Co.*, 2015 WL 71493 (D. Mass. Jan. 6, 2015).

In May 2011, the SEC commenced an investigation by Formal Order of BioChemics and its officers. The SEC issued subpoenas. During this time frame, the company was insured by Greenwich Insurance Company. However, beginning November 2011, BioChemics became insured by Axis Reinsurance. Shortly after the inception of the Axis policy, the SEC served additional subpoenas on BioChemics and its officers under the same SEC matter identification number and caption as the initial Formal Order and subpoenas. In December 2012, the SEC filed an Enforcement Action against the company and several individuals. Axis denied coverage, arguing that the entire SEC investigation constituted a single "claim" that was first made in May 2011 and therefore was outside the scope of policy coverage. The court agreed.

The Axis policy defined a "claim" to include any "civil, arbitration, administrative or regulatory proceeding." The policy further provided that all claims "arising from the same Wrongful Act … and all Interrelated Wrongful Acts shall be deemed one Claim and such Claim shall be deemed to be first made on the earlier date that: (1) any of the Claims is first made against an Insured under this Policy or any prior policy …." The court held these policy provisions, read together, supported the conclusion that all SEC actions taken against BioChemics and its officers over the two-year period were part of a single "claim." Additionally, the court concluded that the claim was first made in May 2011 (during the Greenwich policy period) and was therefore not subject to coverage under the Axis policy. Notably, the court reached this conclusion notwithstanding the fact that some of the misrepresentations alleged in the SEC enforcement complaint took place during the Axis policy period.

Along similar lines, the Eighth Circuit ruled that a professional liability insurer owed no coverage where a claim was deemed "made" during a 2007 policy period, but was not reported to the insurer until after the inception of a 2008 policy period. *Philadelphia Consol. Holding Corp. v. LSI-Lowery Sys., Inc.*, 2015 WL 127368 (8th Cir. Jan. 9, 2015).

The coverage dispute arose out of troubled software programs developed and installed

by LSi and sold to Hodell in 2007. Software-related problems arose immediately after installation. In March 2007, Hodell initiated a series of email communications with LSi expressing dissatisfaction with the software and threatening legal action. Email exchanges, including demands for reimbursement and threats of litigation, continued through July 2007. During this period, Hodell retained counsel and attempted to resolve the problems. Finally, in November 2008, Hodell sued LSi and others asserting fraud, breach of contract and negligence. Shortly thereafter, LSi notified its professional liablity insurer of the claims. The insurer denied coverage under successive 2007 and 2008 policies. A Missouri federal district court upheld the insurer's denial, finding no coverage under either policy. The Eighth Circuit affirmed.

The Eighth Circuit ruled that LSi did not give notice of a claim or potential claim within the policy period, as required by the 2007 policy's notice provision. The court also held that there was no coverage under the 2008 policy, which provided coverage for "any claim first made against you during the policy period." The court concluded that a claim against LSi was first made prior to the April 2008 policy inception date, finding that the communications between Hodell and LSi from March 2007 through mid-2008 constituted a claim. In particular, the court reasoned that Hodell's complaints and demands for remediation and costs, as well as its threats to seek legal recourse, taken together, established the existence of a claim, defined in both policies to include a "demand for money." The court noted that even absent a specific dollar demand, a proposal to reach settlement to avoid legal action constitutes a demand for money. Finally, the court rejected the argument that prejudice must be established to deny coverage on the basis of untimely notice, ruling that Missouri law does not require such a showing under a claims-made policy.

Fifth Circuit Affirms That Misappropriation and Unfair Competition Claims Do Not Allege Personal and Advertising Injury

Our April 2014 Alert reported on a Mississippi federal district court decision holding that a general liability insurer had no duty to defend or indemnify misappropriation and unfair competition claims against a policyholder. *Nationwide Ins. Co. v. Lexington Relocation Serv., LLC*, 2014 WL 1213805 (N.D. Miss. Mar. 24, 2014). This month, the Fifth Circuit affirmed. *Nationwide Mut. Ins. Co. v. Gum Tree Prop. Mgmt., L.L.C.*, 2015 WL 170244 (5th Cir. Jan. 14, 2015). The Fifth Circuit held that the use of trade secrets or confidential business information does not constitute "disparagement" and that "the right to privacy" referenced in the personal injury coverage provision does not extend to business organizations. In addition, the Fifth Circuit rejected the policyholder's attempt to invoke Mississippi's "true facts" exception with respect to an insurer's duty to defend. The policyholder argued that even if the underlying complaint did not allege facts within coverage, the insurer was obligated to defend because it was aware of "true facts" that established coverage. According to the policyholder, "true facts" establishing coverage were set forth in the policyholder's answer to the complaint and in affidavits executed by the policyholder's employees. The Fifth Circuit rejected this argument, stating that:

> We do not interpret the "true facts" rule to require an insurance company, when the claim is outside coverage, to consider the denials in an answer when deciding whether to defend or to review affidavits from the insured that support the denials. Such a rule would transform the narrow exception into a broad one.

Florida Court Rules That Statutory Violation Exclusion Bars Coverage for Conversion Claim

A Florida federal district court ruled that an insurer had no duty to defend a suit alleging both statutory and common law conversion claims because the policy's Violation of Statutes exclusion barred coverage for both claims. *Am. Cas. Co. of Reading, Pa. v. Superior Pharmacy, LLC*, No. 8:13-cv-622 (M.D. Fla. Jan. 8, 2015).

A class action was filed against the policyholder alleging violations of the Telephone Consumer Protection Act ("TCPA") and conversion, based on the transmission of unsolicited fax advertisements. American Casualty sought a declaration that it had no duty to defend or indemnify the claims based on the Violation of Statutes exclusion, which barred coverage for damage "arising directly or indirectly out of any action or omission that violates or is alleged to violate" the TCPA. Although the policyholder did not dispute that the exclusion barred coverage for the TCPA claim, it argued that it did not apply to the common law conversion claim. The court disagreed.

The court concluded that the conversion claim "arose out of" an alleged violation of the TCPA because it was based on the same operative facts. The court noted that under Florida law, the phrase "arising out of" is broader than the term "caused by" and is comparable to "having a connection with." The court found it immaterial that the conversion claim arose under common law and required different elements of proof and sought independent damages. Additionally, the court dismissed the policyholder's argument that the statutory exclusion did not bar coverage for the conversion claim because some of the faxes might constitute conversion yet not violate the TCPA. In rejecting this contention, the court explained that possible factual defenses to the TCPA claim were irrelevant to the duty to defend analysis because regardless of the merits of the TCPA claim, the "conversion claim arises out of conduct alleged to have violated the TCPA."

Policyholders have frequently sought coverage for TCPA-related claims under general liability policies. The first wave of TCPA coverage litigation focused on whether such claims alleged a violation of the "right to privacy" under personal and advertising injury provisions. *See* March 2010 Alert; October 2011 Alert; October 2012 Alert. Subsequent coverage litigation addressed whether TCPA-based damages constitute uninsurable punitive damages. *See* June and September 2013 Alerts. With many general liability insurance policies now including statutory violation exclusions, more recent decisions have addressed the application of such exclusions to TCPA or related non-statutory claims. *See* April and May 2014 Alerts.

Discovery Alert:

Courts Reach Conflicting Conclusions as to Whether an Insurer Waived Privilege by Putting Advice of Counsel At Issue

In two recent decisions, the Arizona Court of Appeals and the Tenth Circuit reached different conclusions as to whether an insurer waived attorney-client privilege by putting the advice of counsel at issue.

In *Everest Indem. Ins. Co. v. Rea*, 2015 WL 195450 (Ariz. Ct. App. Jan. 15, 2015), the Arizona Court of Appeals accepted "special action jurisdiction" to address whether an insurance company impliedly waived attorney-client privilege by asserting subjective good faith as a defense in a bad faith action. The court held that it did not.

A policyholder alleged that Everest settled an underlying suit in bad faith. Everest countered that the decision to settle was made in good faith "based on its subjective beliefs concerning the relative merits of the various courses of action." Although Everest acknowledged that it communicated with counsel in making that decision, it did not specifically assert that it relied on the advice of its attorneys in opting to settle. The court held that such conduct was insufficient to establish "at issue" waiver of privilege.

Under Arizona law, in order to waive privilege by putting the advice of counsel at issue, "a party must do more than simply confer with counsel and take action incorporating counsel's advice." Rather, waiver may be implied only "when, after receiving advice from an attorney, a party makes an affirmative assertion that it was acting in good faith *because* it relied on counsel's advice to inform its own evaluation and interpretation

of the law." In other words, implicit waiver requires the assertion of a claim or defense that is "dependent on" the advice of counsel; the mere fact of consultation with counsel (or, as was the case here, participation of counsel in settlement negotiations) is not enough. Applying this standard, the court concluded that Everest did not impliedly waive privilege by putting the advice of counsel at issue. In so ruling, the court noted that Everest had not expressly cited the advice of counsel in support of its subjective good faith.

In contrast, the Tenth Circuit ruled that an insurer waived attorney-client and work-product privilege by putting the advice of its counsel at issue in litigation with a broker. *Seneca Ins. Co. v. Western Claims, Inc.*, 2014 WL 724071 (10th Cir. Dec. 22, 2014).

A property owner sought coverage for hail damage from Seneca Insurance. Seneca hired Western Claims to investigate the claim, who estimated the claim value at approximately $1,000. Seneca paid that amount and closed its file. Several months later, the property owner sought to reopen the file based on a roofing estimate of approximately $750,000. When Seneca refused to pay, the owner brought suit alleging breach of contract and bad faith. During litigation, Seneca sought advice from two attorneys. Based on the legal advice received, Seneca settled with the property owner for $1 million. Seneca then sued Western Claims alleging negligence and seeking to recover the settlement payment. During discovery, Seneca disclosed a claim note that stated that Seneca had settled with the property owner "on advice of Counsel." Western Claims then sought to compel Seneca to produce documents relied upon by Seneca in settling the hail damage claim. Seneca refused, claiming attorney-client privilege and work-product protection. The district court granted Western Claims' motion to compel and the Tenth Circuit affirmed.

The Tenth Circuit concluded that Seneca had waived privilege by putting the advice of counsel "at issue" in the litigation against Western Claims. Although the Oklahoma Supreme Court has not endorsed a specific test for determining "at issue" waiver, the Tenth Circuit held that such waiver requires that the party asserting privilege took "some affirmative act" that put the protected information at issue "by making it relevant to the case." The Tenth Circuit further held that at issue waiver requires a showing that enforcing privilege would deny the opposing party access to information "vital to [its] defense." The court found that these elements were established here because Seneca took the affirmative act of filing suit against Western Claims and then relied on the advice of counsel to justify the reasonableness of the settlement. The court also deemed the material "vital" to Western Claims because the advice of counsel was the only basis asserted for justification of the settlement. *Seneca Insurance* serves as an important reminder that "attorney-client communications cannot be used both as a sword and a shield."

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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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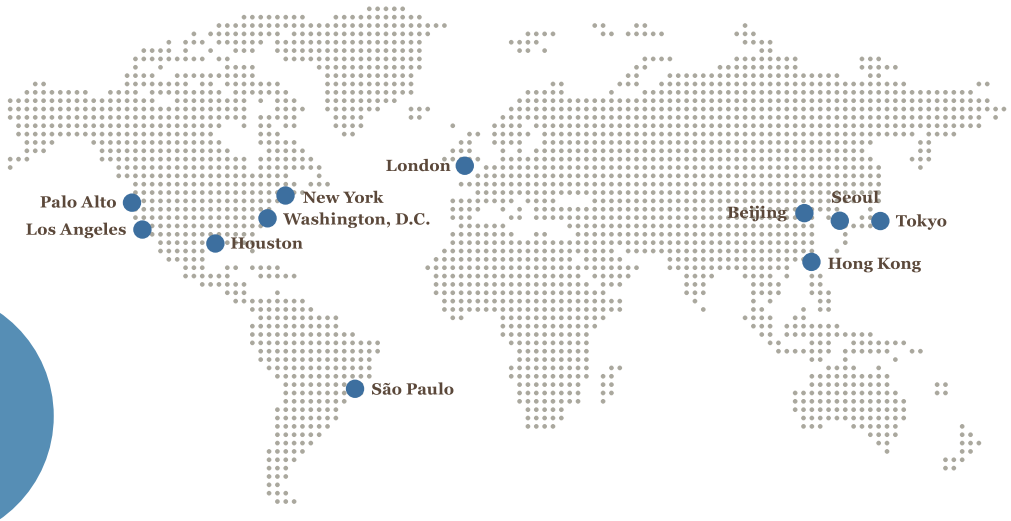

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