Simpson Thacher

Insurance Law Alert

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In This Issue

Second Circuit Rules That Property Policies Do Not Cover Crumbling Concrete Claims

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A Washington district court ruled that a federal bankruptcy court erred in approving a plan that commuted certain insurance policies while enjoining non-settling insurers from pursuing claims against the repurchasing insurers. *In re Fraser's Boiler Serv., Inc.*, 2019 WL 1099713 (W.D. Wash. Mar. 8, 2019). (Click here for full article)

South Carolina Supreme Court Rules That Non-Signatories Are Not Bound By Arbitration Clause In Insurance Agency Agreement

The South Carolina Supreme Court ruled that non-signatories to an insurance agency agreement were not required to arbitrate claims against the parties to the agreement. *Wilson v. Willis*, 2019 WL 1549924 (S.C. Apr. 10, 2019). (Click here for full article)

Second Circuit Reinstates Rescission Claim Based On Misrepresentations

The Second Circuit ruled that an insurer can pursue a rescission claim based on misrepresentations in the policy application, notwithstanding that the insurer's declaratory judgment claim as to coverage was dismissed as non-justiciable. *U.S. Underwriters Ins. Co. v. Orion Plumbing & Heating Corp.*, 2019 WL 1253325 (2d Cir. Mar. 18, 2019). (Click here for full article)

Insurer May Not Depreciate Labor Costs In Calculating Actual Cash Value, Says Tennessee Supreme Court

The Tennessee Supreme Court ruled that policy language did not permit an insurer to depreciate labor costs in calculating actual cash value under a property policy. *Lammert v. Auto-Owners (Mutual) Ins. Co.*, 2019 WL 1592687 (Tenn. Apr. 15, 2019). (Click here for full article)

New York Department Of Financial Services To Begin Enforcement Of Cybersecurity Regulations

The grace period for implementation of the cybersecurity regulations enacted by the Department of Financial Services ended on March 1, 2019. (Click here for full article)

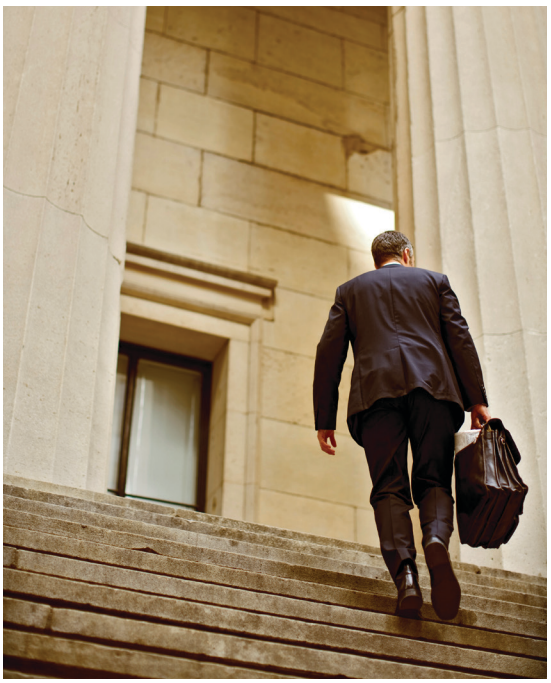
Collapse Alerts:

Second Circuit Rules That Property Policies Do Not Cover Crumbling Concrete Claims

The Second Circuit ruled that a collapse reinstatement provision in Connecticut homeowners' policies does not make coverage available for claims arising from the cracking of basement walls that remain standing. *Valls v. Allstate Ins. Co.*, 2019 WL 1442081 (2d Cir. Apr. 2, 2019).

The homeowners' basement walls were constructed with allegedly defective concrete. They sought coverage for cracking of the walls under all-risk policies issued by Allstate. The policies expressly exclude coverage for damage arising from a collapse, but reinstate coverage for a limited class of collapse events, including a "sudden and accidental direct physical loss caused by . . . hidden decay . . . [or] defective methods or materials." The provision also states that "[c]ollapse does not include settling, cracking, shrinking, bulging or expansion."

Applying Connecticut law, the Second Circuit ruled that the collapse reinstatement provision did not provide coverage for the cracking of the basement walls caused by gradual deterioration of its concrete. The court reasoned that gradual erosion could not be deemed "sudden," and that in any event, the provision expressly exempted settling and cracking from the scope of coverage. Based on this ruling, the Second Circuit also affirmed dismissal of cracking concrete coverage claims in two other cases (*Lees v. Allstate Ins. Co.*, 2019 WL 1466939 (2d Cir. Apr. 2, 2019) and *Carlson v. Allstate Ins. Co.*, 2019 WL 1466935 (2d Cir. Apr. 2, 2019)). A few days before the Second Circuit rulings, a Connecticut federal district court reached a similar conclusion in a dispute involving the same policy language. *Huschle v. Allstate Ins. Co.*, 2019 WL 1427143 (D. Conn. Mar. 29, 2019).



Finding Ambiguity In Collapse Provision, Washington Appellate Court Reverses And Rules In Insured's Favor

Last month's Alert reported on a First Circuit decision holding that a collapse provision was ambiguous and must be interpreted in the policyholder's favor. *Easthampton Congregational Church v. Church Mut. Ins. Co.*, 2019 WL 851191 (1st Cir. Feb. 22, 2019). This month, a Washington appellate court relied on that decision and deemed a nearly-identical provision ambiguous. *Feenix Parkside LLC v. Berkley N. Pac.*, 2019 WL 1514086 (Wash. Ct. App. Apr. 8, 2019).

The operative policy provision covered collapse caused by "[d]ecay that is hidden from view." The coverage dispute centered on whether the undefined term "decay" was ambiguous. A Washington trial court ruled that it was not, finding that it could reasonably be interpreted to include only "some kind of decomposition." Based on this interpretation, the trial court granted the insurer's summary judgment motion, finding that the failure of the building's roof system due to defective construction methods and excessive temperatures did not constitute "decay."

The appellate court reversed, deeming the provision ambiguous. Citing *Easthampton Congregational Church*, the appellate court explained that "decay" could reasonably be interpreted broadly to include a gradual decline in soundness or strength. The court noted that if the insurer had intended to limit "decay" to organic rot, it could have expressly done so.

Cyber Coverage Alerts:

Insureds Seek Reversal Of No Duty To Defend Ruling In Data Breach Suit

A policyholder asked the Eleventh Circuit to reverse a Florida district court decision holding that a general liability insurer has no duty to defend data breach claims. Brief of Appellant, *St. Paul Fire & Marine Ins. Co. v. Rosen Hotels & Resorts, Inc.*, No. 18-14427 (11th Cir. filed Jan. 9, 2019).

The district court ruled that coverage for breach of privacy allegations arising from a data breach is available where the publication of personal information was done by the policyholder itself and does not extend to acts undertaken by third-parties. *St. Paul Fire & Marine Ins. Co. v. Rosen Millennium, Inc.*, 2018 WL 4732718 (M.D. Fla. Sept. 28, 2018) (discussed in our October 2018 Alert). The district court granted in part St. Paul's summary judgment motion, finding that the insurer had no duty to defend under the policy's "personal injury" provision, which applied to several enumerated offenses, including "[m]aking known to any person or organization covered material that violates a person's right of privacy." The court based this ruling on the fact that the alleged privacy violation did not result from Millennium's conduct, but rather arose from the actions of third-party hackers. The district court relied on *Innovak Int'l, Inc. v. Hanover Ins. Co.*, 280 F. Supp.3d 1340 (M.D. Fla. 2017) (discussed in our December 2017 Alert), in which the court held that coverage attaches under a personal injury provision only where the insured publishes private information. A New York court reached the same conclusion in *Zurich Am. Ins. Co. v. Sony Corp. of America*, No. 651982/2011 (N.Y. Sup. Ct. New York Cty. Feb. 21, 2014), holding that a similar personal injury policy provision did not encompass hacking claims where the publication was committed by hackers rather than the insured itself (discussed in our March 2014 Alert).

On appeal to the Eleventh Circuit, the policyholder has argued, among other things, that the district court incorrectly implied a requirement into the liability policy by requiring the insured to be the publishing party in order for coverage to apply. We will keep you posted on any developments in this matter.

Pennsylvania Court Rules That Insurer Must Defend Cyberbullying Claims Arising From Suicide

A Pennsylvania district court ruled that a homeowner's insurer must defend cyberbullying claims arising from a teenager's suicide, finding that a covered "occurrence" was alleged. *State Farm Fire & Cas. Co. v. Motta*, 356 F. Supp. 3d 457 (E.D. Pa. 2018).

A high school student died by suicide after being the target of cyberbullying by a fellow student. The decedent's parents sued the alleged bully and his parents, alleging that he negligently caused their daughter's death. State Farm defended the suit under a reservation of rights and filed a declaratory judgment action, seeking a ruling that it had no duty to defend or indemnify the claims. State Farm argued that there was no covered "occurrence" (defined as an "accident') because the alleged bully sent the text messages intentionally. The court disagreed and granted a motion for judgment on the pleadings as to State Farm's duty to defend.

Addressing this matter of first impression under Pennsylvania law, the court held that the underlying suit alleged an occurrence because suicide was not a foreseeable injury from the alleged bully's perspective. The court distinguished cases involving intentional physical acts by the insured, noting that the causal chain in such cases was direct, whereas a "more complex" and "nuanced" chain of alleged causation existed between the text messages and the self-inflicted death. The court also emphasized that although the underlying complaint used words such as "intentional" and "harassment," it alleged

negligence rather than intentional torts. Notably, the court expressed no opinion as to whether it would reach a different outcome if the decedent's parents alleged only a claim for intentional infliction of emotional distress.

Coverage Alerts:

Fifth Circuit Rules That Insurer Owes Defense To Church In Election Law Violation Suit

The Fifth Circuit ruled that an insurer was obligated to defend a church against claims alleging Texas Election Code violations. *Word of Life Church of El Paso v. State Farm Lloyds*, 2019 WL 1324845 (5th Cir. Mar. 22, 2019).

El Paso Mayor John Cook sued the Word of Life Church, alleging violations of the Texas Election Code. The suit alleged that Tom Brown, pastor, president and chairman of the church, violated state law by circulating and submitting petitions seeking a recall election to remove Cook and two other elected representatives from office. A Texas appellate court concluded that the church violated the Election Code and issued injunctive relief requiring decertification of the recall petition. Thereafter, the parties entered into a judgment agreement for $475,000.

The church sought indemnification for the judgment and $450,000 in attorneys' fees from State Farm under a D&O policy that provided coverage for "wrongful acts" defined as "any negligent acts . . . directly related to the operations of your church." When State Farm denied coverage, the church brought suit, alleging breach of contract and bad faith. A Texas district court granted State Farm's summary judgment motion, concluding that it had no duty to defend or indemnify. The district court reasoned that Brown's actions relating to the recall election were not "directly related to the operations" of the church. The Fifth Circuit reversed.

Applying an "eight corners analysis," the Fifth Circuit held that the underlying allegations of Election Code violations gave rise to a duty to defend. The Fifth Circuit explained that the complaint sufficiently alleged a direct relationship between Brown's activities and church operations because the complaint claimed that Brown, in his capacity as church director and pastor, caused the church to violate state law. In so ruling, the court noted that the district court erred in focusing on whether political actions were within the realm of "typical" church operations, rather than on the particular conduct alleged in the complaint. The Fifth Circuit also ruled that a criminal acts exclusion did not negate the duty to defend because the Texas Election Code does not specify that a violation of its provisions constitutes a criminal act. As to the duty to indemnify, the court ruled that issues of fact existed as to whether Brown's conduct was directly related to church operations.

Restaurant's Superstorm Sandy Losses Not Covered Under Civil Authority Provision, Says New Jersey Appellate Court

A New Jersey appellate court ruled that a restaurant that was closed for several weeks following Superstorm Sandy was not entitled to coverage under a "civil authority" provision. *Maritime Park, LLC v. Nova Cas. Co.*, 2019 WL 1422918 (N.J. Super. Ct. App. Div. Mar. 29, 2019).

Maritime Park, the owner of a restaurant located in a municipal park on the New Jersey waterfront, was forced to close operations for several weeks following Superstorm Sandy. The New Jersey Department of Environmental Protection issued an order closing the park prior to landfall of the storm. The restaurant remained closed for several weeks and thereafter operated on a curtailed schedule. During the relevant time frame, Maritime Park was insured by Nova Casualty, which paid approximately $82,000 under a utility services provision based on the restaurant's power outage. Maritime Park sought additional coverage under a civil authority provision, which the insurer

denied. A New Jersey trial court granted Nova Casualty's summary judgment motion, and the appellate court affirmed.

The civil authority provision states: "When a Covered Cause of Loss causes damage to property other than property at the described premises, we will pay for the actual loss of Business Income you sustain and necessary Extra Expense caused by action of civil authority that prohibits access to the described premises." The appellate court explained that this language requires the prohibition on access to the property to be the result of damage caused by a "covered cause of loss." The policy expressly excluded water as a covered cause of loss, including damage caused by water in combination with wind, storm surge or other perils. The court therefore held that even if the state agency's closure order caused Maritime Park to lose business revenue, the civil authority provision was inapplicable because the circumstances did not involve a "covered cause of loss." In so ruling, the court noted that "[i]t is inconsequential that Maritime's property itself was not damaged by flooding. Due to the anti-concurrent cause provision, the Civil Authority language affords no coverage where the restrictions on Park access were produced, at least in part, by flooding."

Bankruptcy Alert:

Washington Court Rejects Plan That Commutes Certain Policies While Enjoining Claims By Non-Settling Insurers

A Washington district court ruled that a federal bankruptcy court erred in approving a plan that commuted certain insurance policies while enjoining non-settling insurers from pursuing claims against the repurchasing insurers. *In re Fraser's Boiler Serv., Inc.*, 2019 WL 1099713 (W.D. Wash. Mar. 8, 2019).

Fraser's Boiler Service ("FBS"), a former manufacturer of asbestos-containing products, became insolvent. A receiver took over its assets for the sole purpose of paying asbestos claims. FBS was not eligible for an asbestos trust under § 524(g) of the Bankruptcy Code because it had no ongoing business. FBS proposed a reorganization plan in which FBS would sell back general liability policies to certain insurers for $11.66 million in exchange for mutual releases. The settlement was styled as a § 363 sale free and clear of claims related to the repurchased policies. The plan also enjoined non-settling insurers from asserting contribution or indemnity claims against the commuting insurers. A bankruptcy court approved the plan over the non-settling insurers' objections. The district court reversed.

The district court ruled that the bankruptcy court lacked jurisdiction to issue a final judgment and that Ninth Circuit precedent prohibited a sale free and clear of third-party claims. Although the district court ruled that the bankruptcy court did not have "core" jurisdiction to enjoin the non-settling insurers' claims, it concluded that the bankruptcy court had "non-core" jurisdiction over the sale and injunction based on the "undeniable relationship" between the inter-insurer claims and FBS's ability to sell back its policies. The district court also ruled that the bankruptcy court did not have authority to issue an injunction in light of § 524(e) which mandates that "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." In rejecting the injunction, the court emphasized that Ninth Circuit precedent unequivocally precludes bankruptcy courts from discharging the liabilities of non-debtors. The court noted that some bankruptcy courts have distinguished that precedent and allowed such injunctions under certain circumstances, but deemed those decisions erroneous. The court noted that even if it were to recognize an exception so as to allow an injunction of inter-insurer claims, the injunction at issue would still be impermissible as overly broad.

Finally, the court held that the bankruptcy court lacked power to approve the sale of

the policies free and clear of the non-settling insurers' claims under § 363. The court explained that the inter-insurer claims were not "an interest in [FBS's] property," as required by § 363(f), and that the sale did not comply with § 363(f)(1), which requires non-bankruptcy law to permit the sale of such property free and clear. As to the latter issue, the court noted that Ninth Circuit precedent did not permit the sale and that in any event, the settlement did not adequately protect the interests of the non-settling insurers.

Arbitration Alert:

South Carolina Supreme Court Rules That Non-Signatories Are Not Bound By Arbitration Clause In Insurance Agency Agreement

The South Carolina Supreme Court ruled that non-signatories to an insurance agency agreement were not required to arbitrate claims against the parties to the agreement. *Wilson v. Willis*, 2019 WL 1549924 (S.C. Apr. 10, 2019).

Numerous policyholders and insurance agents filed lawsuits against an insurance agent, a broker and six insurance companies, alleging fraud and unfair trade practices, among other claims. The suits alleged that the agent and broker forged documents and engaged in unfair and illegal tactics to "corner the retail insurance market" and that the insurers failed to properly supervise those individuals. Three insurers moved to compel arbitration based on an arbitration clause in their Agency Agreement. The insurers argued that the plaintiffs were third-party beneficiaries to the Agency Agreement and/or were equitably estopped from asserting their non-party status. A trial court denied the motions. An appellate court reversed, ruling that plaintiffs were equitably estopped from arguing that their status as non-signatories to the Agency Agreement precluded enforcement of the arbitration clause because plaintiffs sought to benefit from enforcement of other provisions in that agreement.

The South Carolina Supreme Court reversed. As a preliminary matter, the court emphasized that the presumption in favor of arbitration applies to claims that are encompassed by an arbitration agreement, but not to the identity of the parties who are bound by such an agreement. With respect to the equitable estoppel issue, the court emphasized that in order for non-signatories to be precluded from relying on their non-signatory status, they must seek a "direct benefit" from the contract containing the arbitration clause. In other words, for equitable estoppel to apply, non-signatories must "consistently maintain[] that other provisions of the same contract should be enforced to benefit [them]."

The South Carolina Supreme Court concluded that this standard was not met because the plaintiffs "have not knowingly exploited and received a direct benefit from the Agency Agreement." The court noted that plaintiffs were not aware of the existence of the Agency Agreement until they brought their tort actions against the defendants. The court acknowledged that while some of the claims (*e.g.*, failure to issue policies, *respondeat superior*) would not have arisen in the absence of the Agency Agreement, "direct benefits estoppel is not implicated simply because a claim relates to or would not have arisen 'but for' a contract's existence." The court stated: "when the benefits to a nonsignatory are merely indirect, arbitration cannot be compelled."

Rescission Alert:

Second Circuit Reinstates Rescission Claim Based On Misrepresentations

The Second Circuit ruled that an insurer can pursue a rescission claim based on a policyholder's misrepresentations in the policy application, notwithstanding that the insurer's declaratory judgment claim as to coverage was dismissed as non-justiciable. *U.S. Underwriters Ins. Co. v. Orion Plumbing & Heating Corp.*, 2019 WL 1253325 (2d Cir. Mar. 18, 2019).

Underwriters cancelled a policy issued to Orion based on the non-payment of premiums. Prior to cancellation, a property owner named as a defendant in a personal injury suit filed a third party complaint against Orion, a construction company. The claims against the property owner were dismissed.

Underwriters sued Orion seeking a declaration of no coverage for the underlying claims and rescission *ab initio* of the policy based on misrepresentations in the application relating to the nature of Orion's construction work. A New York district court ruled that Underwriters failed to present a case or controversy, finding that "an attenuated chain of contingencies" would have to occur before Orion could seek coverage from Underwriters. Underwriters did not appeal the dismissal of the declaratory judgment claim, but objected to dismissal of the rescission claim.

The Second Circuit reversed, finding that Underwriters alleged a justiciable claim for rescission, even absent a pending coverage claim. The Second Circuit reasoned that Underwriters alleged a "reasonable likelihood that it will face liability to Orion, based, at minimum, on its duty to defend Orion" against any claims by the property owner or other litigation arising out of the underlying injury. Further, the court noted that Underwriters alleged that Orion misrepresented the nature of its work when it applied for coverage and that it would have charged a higher premium, issued a different policy, or declined to issue coverage altogether had it known the true nature of Orion's construction work. The court concluded that these collective allegations were sufficient to establish a case or controversy as to rescission.

Property Insurance Alert:

Insurer May Not Depreciate Labor Costs In Calculating Actual Cash Value, Says Tennessee Supreme Court

Courts across jurisdictions have reached different conclusions as to whether labor costs can be depreciated for the purposes of calculating actual cash value ("ACV") under a property policy. (*See* March 2017 Alert, January and February 2016 Alerts). This month, the Tennessee Supreme Court weighed in, ruling that policy language did not expressly permit an insurer to depreciate labor costs in determining ACV. *Lammert v. Auto-Owners (Mutual) Ins. Co.*, 2019 WL 1592687 (Tenn. Apr. 15, 2019).

Two sets of homeowners filed a putative class action against Auto-Owners, alleging that the insurer improperly depreciated both labor costs and materials in calculating the ACV of damaged property. One policy defined ACV as "the cost to replace damaged property with new property of similar quality and features reduced by the amount of depreciation applicable to the damaged property immediately prior to loss." The other policy did not define ACV but stated that it includes a deduction for depreciation. Neither policy specifically mentioned labor costs.

The Tennessee Supreme Court ruled that the language in both policies is ambiguous. The court explained that inclusion of the

terms "damaged property" and "prior to loss" suggests that depreciation applies only to materials because labor is intangible and labor costs are post-loss expenses. Additionally, the court noted that the policies' definition of depreciation as "a decrease in value because of age, wear, obsolescence or market value" indicated that it did not include labor because labor does not age, wear or become obsolete. Construing these ambiguities in favor of the insureds, the court concluded that depreciation could be applied only to the costs of materials.

As discussed in our December 2018 Alert, the Eighth Circuit affirmed an Arkansas district court decision certifying a class of homeowners who alleged that a property insurer improperly withheld amounts for labor depreciation when making claim payments. *Stuart v. State Farm Fire & Cas. Co.*, 2018 WL 6358447 (8th Cir. Dec. 6, 2018).

Regulatory Alert:

New York Department Of Financial Services To Begin Enforcement Of Cybersecurity Regulations

As discussed in our May 2018 Alert, the Department of Financial Services ("DFS") enacted cybersecurity regulations applicable to entities subject to New York banking, insurance and financial services laws ("Covered Entities"). The regulations impose certain minimum requirements on Covered Entities for cybersecurity practices, including the maintenance of a cybersecurity program and response plan, the designation of a senior officer to oversee cybersecurity, routine risk assessment, notification of a security incident to the DFS and annual compliance certification. *See* N.Y. Comp. R. & Regs. tit. 23 § 500 (2017).

Since the March 2017 enactment of the regulations, a series of transition periods have provided Covered Entities with time to implement policies that comply with the regulations. This grace period ended on March 1, 2019, with all Covered Entities now obligated to have written cybersecurity policies and procedures in place. In coming months, the DFS's approach to enforcement of its regulations will reveal the extent of permissible flexibility in a Covered Entity's cybersecurity program. One notable area of interest to many Covered Entities is the manner and extent to which the DFS will enforce cybersecurity requirements relating to information held by third-party vendors, particularly given the broad scope of "vendor" under the new regulations. Under the regulations, Covered Entities are obligated to regularly audit vendors to ensure compliance with cybersecurity measures. Additionally, as official enforcement of the regulations gets underway, the DFS may have the opportunity to clarify the scope of events that constitute a reportable incident subject to the 72-hour window for reporting data breaches. We will keep you informed of developments relating to the enforcement of these regulations.

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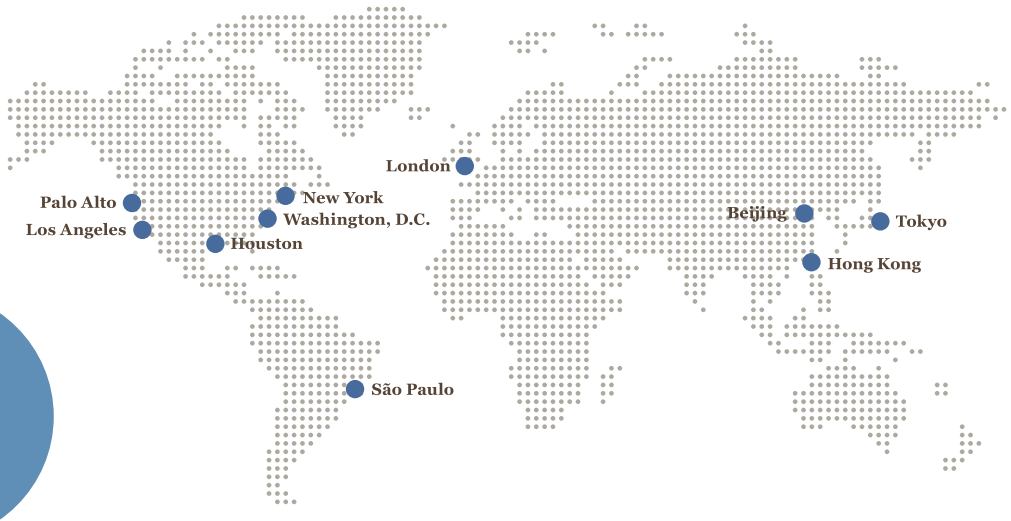

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