Simpson Thacher

Insurance Law Alert

November 2016

In This Issue

Fifth Circuit Rules That Computer Fraud Provision Does Not Encompass Fraudulently-Induced Wire Transfer Claims

The Fifth Circuit ruled that a computer fraud provision does not grant coverage for claims arising out the transfer of funds to criminal accounts because a fraudulent email was only one part of a chain of events that caused the loss. *Apache Corp. v. Great American Ins. Co.,* 2016 WL 6090901 (5th Cir. Oct. 18, 2016). (click here for full article)

Alabama Court Finds That Insurer Has No Duty To Defend Or Indemnify Data Breach Suit

An Alabama federal district court ruled that an insurance policy does not cover claims alleging that the policyholder's negligence contributed to a data breach that caused financial loss. *Camp's Grocery, Inc. v. State Farm Fire & Casualty Co.,* 2016 WL 6217161 (N.D. Ala. Oct. 25, 2016). (click here for full article)

Delaware Court Rules That Settlement Payments Are Not Uninsurable Disgorgement

A Delaware trial court ruled that class action settlement payments do not constitute uninsurable disgorgement under New York law. *TIAA-CREF Individual & Institutional Svs., LLC v. Illinois Nat'l Ins. Co.,* 2016 WL 6534271 (Del. Superior Ct. Oct. 20, 2016). (click here for full article)

Alabama Court Addresses Pollution Exclusion And Timing Of Injury For Sewage-Related Claims

An Alabama federal district court ruled that an absolute pollution exclusion does not bar coverage for claims arising out of sewage exposure and that the date of injury is determinative for purposes of policy period analysis, not the date of the injury-causing "occurrence." *Evanston Ins. Co. v. J&J Cable Construction, LLC,* 2016 WL 5346079 (M.D. Ala. Sept. 22, 2016). (click here for full article)

Finding The Phrase "Arising Out Of" Ambiguous, Massachusetts Court Orders Insurer To Defend Cosby Defamation Suit

A Massachusetts federal district court ruled that language in a sexual misconduct policy exclusion was ambiguous and that the insurer was therefore obligated to defend defamation claims related to sexual misconduct allegations. *AIG Prop. Cas. Co. v. Green,* 2016 WL 6637694 (D. Mass. Nov. 8, 2016). (click here for full article)

"Simpson Thacher has many litigators who are very experienced in handling complex, multi-faceted litigation involving novel issues."

***–Benchmark 2017,* quoting a client**

California Court Rejects Conflict of Interest And Untimely Defense Arguments

A California federal district court ruled that an insurer did not breach its duty to defend and was not required to hire independent counsel to defend the policyholder because no conflict of interest existed. *St. Paul Mercury Ins. Co. v. McMillin Homes Construction, Inc.,* 2016 WL 5464533 (S.D. Cal. Sept. 29, 2016). (click here for full article)

Third Circuit Holds That Parties Should Arbitrate Reinsurance Dispute And That Panel Should Determine Applicability of Nebraska's Anti-Arbitration Statute

The Third Circuit granted a motion to compel arbitration, finding that an arbitrator, rather than a court, should address challenges to the arbitration agreement and the applicability of a Nebraska statute barring arbitration of insurance disputes. *South Jersey Sanitation Co., Inc. v. Applied Underwriters Captive Risk Assurance Co.,* 840 F.3d 138 (3d Cir. 2016). (click here for full article)

Tennessee Court Denies Motion to Compel Information Relating To Other Insurance Claims, Claims-Handling and Reinsurance Communications

A Tennessee federal district court denied policyholders' motion to compel the production of information relating to other insurance claims, claims handing, underwriting, loss reserves and reinsurance communications. *First Horizon Nat'l Corp. v. Houston Cas. Co.,* 2016 WL 5869580 (W.D. Tenn. Oct. 5, 2016). (click here for full article)

Data Breach Alerts:

Fifth Circuit Rules That Computer Fraud Provision Does Not Encompass Fraudulently-Induced Wire Transfer Claims

The Fifth Circuit ruled that a computer fraud provision does not grant coverage for claims arising out the transfer of funds to criminal accounts because a fraudulent email was only one part of a chain of events that caused the loss. *Apache Corp. v. Great American Ins. Co.,* 2016 WL 6090901 (5th Cir. Oct. 18, 2016).

Apache, an oil production company, received a telephone call from a person identifying herself as a Petrofac representative (a vendor for Apache). The caller instructed Apache to change bank account information for future payments. The Apache employee replied that the change could not be processed without a formal request on Petrofac letterhead. Thereafter, Apache received an email from an email address created by criminals to closely resemble Petrofac's actual email address. The email attached a letter confirming the request to change the bank account on fraudulently-created letterhead. Apache called the telephone number provided in the letter to confirm the change and then approved the change. After nearly $7 million was paid to the new bank account, Apache discovered that the phone call and email came from criminals. Apache sought coverage from Great American, which denied coverage on the ground that the loss did not "result[ ] directly from the use of a computer," as required by the policy. A Texas district court disagreed and ruled in favor of Apache. The Fifth Circuit reversed.

Addressing this matter of first impression under Texas law, the Fifth Circuit ruled that the computer fraud provision did not cover Apache's claims because the loss resulted from a series of events and was not "directly" caused by computer use. In particular, the court explained that there was no coverage obligation because the wire transfers resulted from the criminals' initial phone call, the subsequent phone call to the fraudulent phone number, and Apache's insufficient internal controls for account changes. The court stated:

> The email was part of the scheme; but, the email was merely incidental to the occurrence of the authorized transfer of money. To interpret the computer-fraud provision as reaching any fraudulent scheme in which an email communication was part of the process, would . . . convert the computer-fraud provision to one for general fraud.

As the Fifth Circuit noted, courts in other jurisdictions have concluded that computer fraud provisions have limited application and apply to claims arising directly out of use of a computer (such as hacking) and not claims that merely involve use of a computer at some point in the transaction.

Alabama Court Finds That Insurer Has No Duty To Defend Or Indemnify Data Breach Suit

An Alabama federal district court ruled that an insurance policy does not provide coverage for claims alleging that the policyholder's negligence contributed to a data breach that caused financial loss. *Camp's Grocery, Inc. v. State Farm Fire & Casualty Co.,* 2016 WL 6217161 (N.D. Ala. Oct. 25, 2016).

Hackers accessed the computer network of Camp's Grocery Store and gained access to confidential customer data. Three credit unions sued Camp's, alleging that it was liable for resulting losses based on its failure

to provide adequate computer training to employees and/or to maintain appropriate security systems. Camp's sued State Farm seeking a declaration that the insurer was obligated to defend and indemnify the credit unions' claims. The court disagreed and granted State Farm's summary judgment motion.

Camp's sought coverage under Inland Marine endorsements that provide coverage "for accidental and direct physical loss" to computer programs and electronic data. The endorsements state that State Farm "may elect to defend you" against suits arising from such claims. The court ruled that the Inland Marine endorsements did not cover data breach claims brought by a third party. The court explained that by referencing "direct physical loss," the endorsements unambiguously provide only first-party coverage for losses sustained by Camp's itself. The court further held that the phrase "may elect to defend you" gives the insurer discretion to defend but does not create a duty to defend.

The court also ruled that coverage was unavailable under the third-party coverage provision for claims arising out of bodily injury or property damage. The court explained that the underlying claims allege economic losses and not property damage. Rejecting Camp's contention that alleged loss stemming from the issuance of replacement credit or debit cards satisfies the property damage requirement, the court explained:

> [E]ven if credit and debit cards are tangible property . . . the Credit Unions do not assert that Camp's acts or omissions caused physical harm or damage to any cards as tangible property. Rather, the Credit Unions assert that Camp's lax computer network security allowed the *intangible electronic data contained on the cards* to be compromised such that the magnetically encoded card numbers could no longer be used, causing purely economic loss . . . . (Emphasis in original).

Coverage Alerts:

Delaware Court Rules That Settlement Payments Are Not Uninsurable Disgorgement

A Delaware trial court ruled that class action settlement payments do not constitute uninsurable disgorgement under New York law. *TIAA-CREF Individual & Institutional Svs., LLC v. Illinois Nat'l Ins. Co.,* 2016 WL 6534271 (Del. Superior Ct. Oct. 20, 2016).

TIAA-CREF was sued in three class action suits that alleged failure to pay customers gains that had accrued in their accounts. TIAA-CREF settled the actions and sought reimbursement of defense costs and settlement payments from its liability and excess insurers. The insurers denied coverage and argued, among other things, that the settlement payments are uninsurable disgorgement under New York law. The court disagreed and granted in part TIAA-CREF's summary judgment motion.

The court ruled that there is "no conclusive link between the settlements in the Underlying actions and wrongdoing by TIAA-CREF that would render the settlement agreements uninsurable disgorgement." Although several New York decisions have upheld coverage denials based on the public policy against insuring disgorgement, the court distinguished those rulings and stated that those cases "involve conclusive links between the insured's misconduct and the payment of monies," whereas here,

TIAA-CREF expressly denied any liability. The court further noted that those cases involved underlying actions brought by the SEC or other governmental entities and distinguished a settlement from "an order to return funds." *See, e.g., J.P. Morgan Securities Inc. v. Vigilant Ins. Co.,* 2013 WL 2475864 (N.Y. June 11, 2013) (discussed in our June 2013 Alert).

The court also addressed several other coverage issues. First, it ruled that St. Paul's policies cover the two class action suits that were filed after the expiration of its policy period because the claims in those suits "related back" to a class action filed during St. Paul's policy period. Second, the court held that coverage is not barred by the policies' commingling exclusions because the record did not indicate that TIAA-CREF had mixed client accounts with its own funds or had used client funds for its own private benefit. Third, the court ruled that an issue of fact exists as to whether TIAA-CREF forfeited coverage by breaching a consent to settlement provision. The court noted that while coverage denials under certain policies might affect the insurers' right to enforce the consent to settlement provisions, a question of fact remains as to whether the insurers retained the right to withhold consent with respect to other policies. Finally, the court concluded that the reasonableness of defense costs presents issues of fact, rejecting the argument that the costs should be deemed *per se* reasonable because of TIAA-CREF's incentive to minimize expenses based on the uncertainty about reimbursement.

Alabama Court Addresses Pollution Exclusion And Timing Of Injury For Sewage-Related Claims

An Alabama federal district court ruled that an absolute pollution exclusion does not bar coverage for claims arising out of sewage exposure and that the date of injury is determinative for purposes of policy period analysis, not the date of the injury-causing "occurrence." *Evanston Ins. Co. v. J&J Cable Construction, LLC,* 2016 WL 5346079 (M.D. Ala. Sept. 22, 2016).

The coverage dispute arose out of personal injury and property damage claims caused by exposure to sewage. A sub-contractor negligently struck sewer pipes during a construction project, resulting in sewage

exposure in several neighboring homes. Evanston denied coverage for the claims based on an absolute pollution exclusion and a policy period defense. The court rejected both arguments.

The court ruled that sewage is not a pollutant within the meaning of the exclusion, and that the terms "discharge" and "dispersal" in the exclusion have been interpreted to refer to traditional environmental pollution under Alabama law. The court also dismissed Evanston's argument that all of the injuries occurred after the policy's November 12, 2013 expiration date. The court found that while some evidence suggested that the underlying claimants did not suffer injury until November 16 or later, other evidence indicated that plumbing problems had begun in the claimants' homes earlier in time, which raised a question of fact as to the timing of injury.

Defense Alerts:

Finding The Phrase "Arising Out Of" Ambiguous, Massachusetts Court Orders Insurer To Defend Cosby Defamation Suit

Our November 2015 Alert reported on a California decision holding that language in a sexual misconduct policy exclusion is ambiguous and that the insurer was therefore obligated to defend defamation claims related to sexual misconduct allegations. *AIG Prop. Cas. Co. v. William H. Cosby,* 2015 WL 9700994 (C.D. Cal. Nov. 13, 2015). This month, a Massachusetts federal district court, faced with similar policy language and underlying allegations, reached the same conclusion. *AIG Prop. Cas. Co. v. Green,* 2016 WL 6637694 (D. Mass. Nov. 8, 2016).

The coverage dispute arose out of several lawsuits against Bill Cosby alleging defamation and intentional infliction of emotional distress. The plaintiffs claimed that in response to their allegations of assault and rape, Cosby made numerous public statements that injured their reputations. Cosby tendered defense of the action to AIG under homeowners and excess policies. AIG sought a declaration that it had no duty to defend or indemnify the suits, arguing that the claims fell within a sexual misconduct exclusion, which bars coverage for "personal injury arising out of any actual, alleged, or threatened by any person . . . sexual molestation, misconduct, or harassment." The court disagreed, denying AIG's summary judgment motion and granting Cosby's motion in part.

The court ruled that there was no conflict between California and Massachusetts law regarding interpretation of "arising out of" in the sexual misconduct exclusion. The court stated that under both states' law, the phrase is ambiguous. The court explained that while sexual misconduct is "no doubt related to and setting the stage for the defamation claims," it is "multiple steps removed from the defamatory injury-causing statements." In deeming the exclusion ambiguous, the court noted that a different policy provision (applicable to "Limited Charitable Board Directors and Trustees Liability") contained broader language excluding sexual misconduct claims ("arising out of, or in any way involving, directly or indirectly, any sexual misconduct"). The court declined to rule on AIG's indemnity obligations, noting that the underlying claims have not yet been resolved.

California Court Rejects Conflict of Interest And Untimely Defense Arguments

A California federal district court ruled that an insurer did not breach its duty to defend and was not required to hire independent counsel for the policyholder because no actual conflict of interest existed. *St. Paul Mercury Ins. Co. v. McMillin Homes Construction, Inc.,* 2016 WL 5464533 (S.D. Cal. Sept. 29, 2016).

McMillin, a general contractor, was an additional insured under a St. Paul policy issued to a landscape company. McMillan tendered defense of a construction defect suit to St. Paul, which it accepted subject to a reservation of rights. After McMillin refused to accept St. Paul's appointed counsel, St. Paul filed suit, seeking a declaration that it had the right to control the underlying defense and had no obligation to pay counsel retained by McMillin. McMillin counterclaimed alleging that St. Paul breached its duty to defend by failing to provide an immediate defense upon tender and by ignoring a conflict of interest that warranted the appointment of independent counsel. The court rejected these contentions and granted St. Paul's summary judgment motion.

The court disagreed that the nearly five-month delay between tender and St. Paul's acceptance of the defense constitutes a breach of St. Paul's duty to provide a timely defense, explaining that the time period between tender and McMillan's production of documents to St. Paul (in response to St. Paul's claim investigation) is not considered in determining whether St. Paul provided a timely defense. The court explained that insurers are entitled to a reasonable period to investigate claims to determine coverage issues. The record established that once McMillin turned over the relevant documents, St. Paul agreed to defend within five to seven weeks. The court held that this delay was reasonable as a matter of law. The court also held that St. Paul was not obligated to appoint independent counsel because McMillin failed to demonstrate an actual, significant conflict of interest and mere "[a]llegations that the insurer had theoretical incentives creating adverse interests 'do not cause a conflict requiring independent counsel.'"

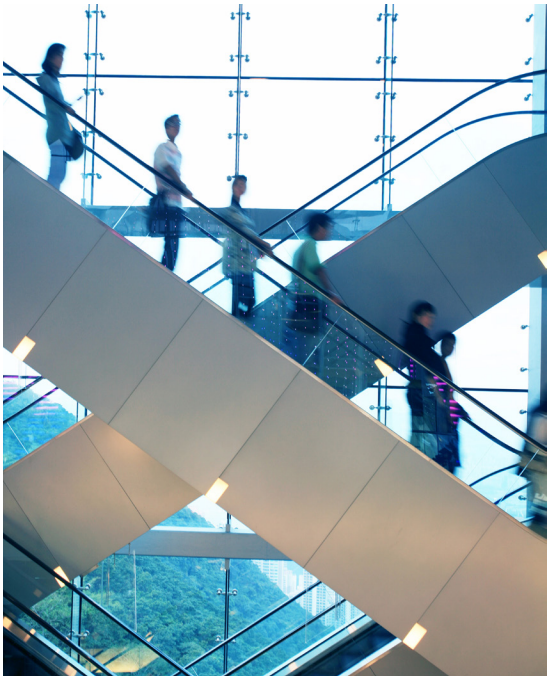
Arbitration Alert:

Third Circuit Holds That Parties Should Arbitrate Reinsurance Dispute And That Panel Should Determine Applicability of Nebraska's Anti-Arbitration Statute

The Third Circuit granted a motion to compel arbitration, finding that an arbitrator should address challenges to the arbitration agreement and the applicability of a Nebraska statute barring arbitration of insurance disputes. *South Jersey Sanitation Co., Inc. v. Applied Underwriters Captive Risk Assurance Co.,* 840 F.3d 138 (3d Cir. 2016).

South Jersey, a garbage collection company, entered into a Reinsurance Participation Agreement ("RPA") with Applied Underwriters. The parties disputed the purpose and effect of the contract; South Jersey contended that the RPA provided coverage for workers' compensation claims whereas Applied Underwriters argued that it operated only as an investment instrument. South Jersey sued Applied Underwriters seeking rescission of the RPA and alleging breach of contract, negligent misrepresentation and fraud. Applied Underwriters moved to compel arbitration based on an arbitration provision in the RPA. A New Jersey federal district court denied the motion and ruled that under the RPA's choice-of-law clause, Nebraska law governed the dispute and that a Nebraska statute barring arbitration of insurance disputes (Neb. Rev. Stat. Section 2602.01) reverse preempts the Federal Arbitration Act pursuant to the McCarran-Ferguson Act. The Third Circuit reversed.

The Third Circuit explained that under the Federal Arbitration Act, fraud-based challenges to an arbitration provision may be resolved by a court. However, "[i]f the challenge encompasses the contract as a whole, the validity of that contract, like all other disputes arising under the contract, is a matter for the arbitrator to decide." The court concluded that South Jersey's fraud claims must be resolved in arbitration because they contest the validity of the RPA as a whole, rather than only the arbitration provision. The court also rejected the district court's reverse-preemption ruling. It reasoned that it is unclear whether the RPA falls within the scope of the Nebraska anti-arbitration statute and that South Jersey's contention that the RPA "clearly relates to, concerns and actually issues a workers' compensation policy" is insufficient to establish that the RPA is "an agreement concerning or relating to an insurance policy," as required by Section 2602.01. The court therefore concluded that the arbitration panel must decide whether the RPA falls within the ambit of Section 2602.01 so as to give rise to a reverse preemption issue.



Discovery Alert:

Tennessee Court Denies Motion to Compel Information Relating To Other Insurance Claims, Claims-Handling and Reinsurance Communications

A Tennessee federal district court denied policyholders' motion to compel the production of information relating to other insurance claims, claims handing, underwriting, loss reserves and reinsurance communications. *First Horizon Nat'l Corp. v. Houston Cas. Co.,* 2016 WL 5869580 (W.D. Tenn. Oct. 5, 2016).

In this dispute arising out of alleged False Claims Act violations, the policyholders sought to compel their liability and excess insurers to produce a broad range of

documents. Denying all but one of the motions, the court held:

Similar Claims Material: The court deemed information relating to the insurers' treatment of other claims to be irrelevant. Rejecting the contentions that such information bears on policy interpretation and the insurers' alleged bad faith denial of the claims, the court explained that even if the insurers took conflicting positions in other cases regarding the same terms, it would not aid the court in interpreting the policy language at issue. Additionally, the court concluded that requiring production of other claims material would be unduly burdensome.

Claims-Handling and Underwriting Material: Policyholders argued that such materials are relevant to the disputed coverage issues pertaining to "interrelated claims" or when an insurable claims accrues. Rejecting this argument, the court explained that such information is irrelevant because the excess policies at issue followed form to underlying primary policies. Thus, even if the excess policies were ambiguous, the underwriting and claim-handling manuals for those policies would be irrelevant.

Reinsurance Agreements and Communications: The court granted policyholders' motion to compel the production of reinsurance agreements, ruling that Federal Rule of Civil Procedure 26(a)(1) (which requires a party to produce "any insurance agreement") encompasses reinsurance agreements. However, the court denied the motion with respect to reinsurance-related communications. Policyholders argued that such communications are relevant because they could "shed light on the Insurers' intent" and "could reveal whether the insurers believed that these policies covered the claims." Rejecting this argument, the court accepted the insurers' contentions (and sworn statements) that reinsurance communications reflect the insurers' business decision to spread risk and not the substantive issues in the coverage litigation.

Loss Reserves: The court noted that some courts have deemed loss reserves relevant to the insurer's valuation of the claim and alleged bad faith, while others have denied production based on the "tenuous link between reserves and the legal question of coverage." The court endorsed the view that reserves set by insurers are a "business judgment and do not reflect a legal determination of the validity of the Plaintiffs' claims against them."

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.

David J. Woll
+1-212-455-3136
dwoll@stblaw.com

Mary Beth Forshaw
+1-212-455-2846
mforshaw@stblaw.com

Andrew T. Frankel
+1-212-455-3073
afrankel@stblaw.com

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

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

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

Michael D. Kibler
+1-310-407-7515
mkibler@stblaw.com

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

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

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

Deborah L. Stein
+1-310-407-7525
dstein@stblaw.com

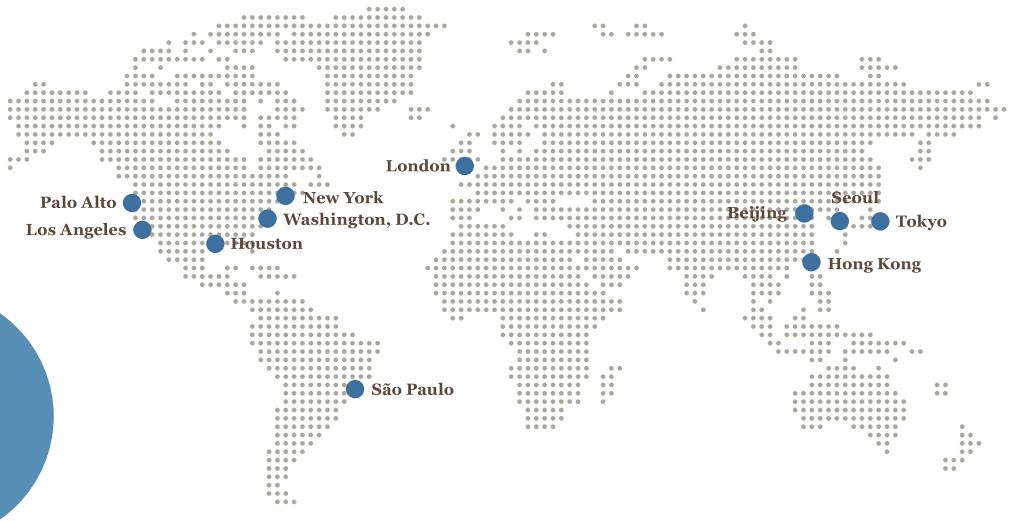
Craig S. Waldman
+1-212-455-2881
cwaldman@stblaw.com

Susannah S. Geltman
+1-212-455-2762
sgeltman@stblaw.com

Elisa Alcabes
+1-212-455-3133
ealcabes@stblaw.com

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

This edition of the Insurance Law Alert was prepared by Mary Beth Forshaw mforshaw@stblaw.com /+1-212-455-2846 and Bryce L. Friedman bfriedman@stblaw.com /+1-212-455-2235 with contributions by Karen Cestari kcestari@stblaw.com.



Simpson Thacher Worldwide

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

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3901 China World Tower
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

Seoul
25th Floor, West Tower
Mirae Asset Center 1
26 Eulji-ro 5-gil, Jung-gu
Seoul 100-210
Korea
+82-2-6030-3800

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