SIMPSON THACHER

# INSURANCE LAW ALERT

DECEMBER 2012

This Alert reports on recent decisions relating to subrogation claims, broker liability, pro rata allocation, and the retroactive application of insurance-related legislation. We also discuss rulings interpreting the anti-assignment provision, the voluntary payments provision, and the pollution exclusion. We also highlight insurance and reinsurance issues that are likely to surface in coverage litigation arising out of Hurricane Sandy. Please "click through" to view articles of interest. Happy Holidays!

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- ***Kentucky Supreme Court Rules That Anti-Assignment Clause Does Not Apply to Pre-Assignment Losses***

  The Supreme Court of Kentucky held that an anti-assignment provision requiring insurer consent prior to the assignment of claims was void as against public policy with respect to losses that occurred before the assignment. *Wehr Constructors, Inc. v. Assurance Co. of America*, 2012 WL 5285774 (Ky. Oct. 25, 2012). *Click here for full article*

- ***Missouri Court Applies Pro Rata Allocation to Environmental Contamination Claims***

  A Missouri court ruled that environmental contamination claims must be allocated on a pro rata basis among multiple policy periods. *Mallinckrodt Inc. v. Continental Ins. Co.*, No. 05CC-001214 (Mo. Cir. Ct. St. Louis Cnty. Nov. 8, 2012). *Click here for full article*

- ***Legislation Requiring Coverage for Faulty Construction Does Not Apply Retroactively, Says South Carolina Supreme Court***

  The South Carolina Supreme Court held that it would be unconstitutional to retroactively apply a statutory definition of the term "occurrence" to general liability policies that were negotiated prior to the statute's effective date. *Harleysville Mutual Ins. Co. v. State*, 2012 WL 5870799 (S.C. Nov. 21, 2012). *Click here for full article*

- ***Policy Clause Prohibiting Policyholder from Admitting Liability is Against Public Policy, Says Illinois Appellate Court***

  An Illinois appellate court ruled that a voluntary payments provision, which prohibited the insured from admitting liability without the insurer's consent, was unenforceable. *Illinois State Bar Assoc. Mut. Ins. Co. v. Frank M. Greenfield and Assocs., P.C.*, 2012 WL 5471875 (Ill. App. Div. Nov. 9, 2012). *Click here for full article*

- ***Court Orders Production of Proof-of-Claim Materials in New York City Asbestos Litigation***

  In a ruling affecting New York City asbestos litigation, a New York judge ordered plaintiffs to disclose all materials submitted in connection with proofs of claims filed with asbestos-related bankruptcy trusts established pursuant to Section 524(g) of the Bankruptcy Code. *In re New York City Asbestos Litigation*, No. 40000/88 (Sup. Ct. N.Y. Cnty. Nov. 16, 2012). *Click here for full article*

- ***Two Courts Allow Excess Insurers to Assert Legal Malpractice Claims Against Policyholder Defense Counsel***

  Mississippi and Illinois courts allowed excess insurers to pursue legal malpractice claims against policyholder defense counsel pursuant to the doctrine of equitable subrogation. *Great American E & S Ins. Co. v. Quintairos, Prieto, Wood & Boyer, P.A.*, 2012 WL 4945958 (Miss. Oct. 18, 2012); *ACE American Ins. Co. v. Sandberg, Phoenix & Von Gontard, PC.*, 2012 WL 4573340 (S.D. Ill. Oct. 2, 2012). *Click here for full article*

- ***Subrogation Provision Does Not Entitle World Trade Center Leaseholders to Proceeds from Insurers' Settlement with Airlines, Says New York Court***

  A New York federal district court held that subrogation provisions did not entitle policyholders to proceeds from their insurers' settlement with alleged tortfeasors unless the policyholders were able to demonstrate that they had legally recoverable tort damages that exceeded their insurance recovery. *In re September 11 Litigation*, 2012 WL 5954585 (S.D.N.Y. Nov. 27, 2012). *Click here for full article*

- ***Policyholder's Failure to Read Policy Does Not Preclude Negligence Claim Against Broker***

  New York's highest court declined to dismiss negligence and breach of contract claims against an insurance broker, reasoning that the policyholder's failure to review the policy did not automatically preclude such claims. *American Bldg. Supply Corp. v. Petrocelli Grp., Inc.*, 2012 WL 5833969 (N.Y. Nov. 19, 2012). *Click here for full article*

- ***Virginia Supreme Court Enforces Pollution Exclusion to Bar Coverage for Drywall-Related Claims***

  The Virginia Supreme Court ruled that four exclusions in a property policy each unambiguously bar coverage for damages arising out of the installation of defective drywall. *Travco Ins. Co. v. Ward*, 2012 WL 5358705 (Va. Nov. 1, 2012). *Click here for full article*

- ***Navigating the Insurance Implications of Superstorm Sandy***

  An analysis of the insurance and reinsurance issues that are likely to arise in post–Hurricane Sandy coverage litigation. *Click here for full article*

## Anti-Assignment Clause Alert:

### *Kentucky Supreme Court Rules That Anti-Assignment Clause Does Not Apply to Pre-Assignment Losses*

Answering a question certified by a Kentucky federal district court, the Supreme Court of Kentucky held that an anti-assignment provision requiring insurer consent prior to the assignment of claims was void as against public policy with respect to losses that occurred before the assignment. *Wehr Constructors, Inc. v. Assurance Co. of America*, 2012 WL 5285774 (Ky. Oct. 25, 2012).

Assurance issued a builder's risk policy to a hospital which contained the following provision: "Your rights and duties under this policy may not be transferred without [Assurance's] written consent except in the case of death of an individual named insured." The hospital sought but was denied coverage for damages incurred in connection with the installation of new flooring. Ultimately, the hospital settled with the flooring contractor and assigned to the contractor its coverage claim against Assurance. The contractor in turn sued Assurance, seeking coverage for the costs of the property damage. Assurance denied coverage, this time on the basis of the anti-assignment provision. The central question before the court was whether the anti-assignment provision was enforceable with respect to pre-assignment claims.

The Kentucky Supreme Court held that although the anti-assignment provision was unambiguous, it was void as against public policy with respect to losses that had occurred prior to the assignment (*i.e.*, claims that constituted a "chose in action"). The court reasoned that once a claim is a chose in action, it is a form of personal property which should not be subject to restraints. In addition, the court explained that where covered losses have occurred prior to an assignment, insurance coverage has already been implicated, and the insurer is not subject to unforeseen exposure or increased risk. Employing similar reasoning, other courts have declined to enforce anti-assignment clauses to losses that pre-date the assignment. *See Pilkington North America, Inc. v. Travelers Cas. & Sur. Co.*, 112 Ohio St.3d 482, 861 N.E.2d 121 (Ohio 2006); *SR Int'l Bus. Ins. Co., Ltd. v. World Trade Center Props., LLC*, 375 F. Supp.2d 238 (S.D.N.Y. 2005).

## Allocation Alert:

### *Missouri Court Applies Pro Rata Allocation to Environmental Contamination Claims*

Ruling on a matter of first impression under Missouri law, a Missouri court ruled that environ-

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mental contamination claims must be allocated on a pro rata basis among multiple policy periods. *Mallinckrodt Inc. v. Continental Ins. Co.*, No. 05CC-001214 (Mo. Cir. Ct. St. Louis Cnty. Nov. 8, 2012). The court noted that prior case law in Missouri reached mixed outcomes on allocation, but determined that decisions employing pro rata allocation, rather than "all sums" allocation, were better reasoned in the context of "continuing damages incapable of temporal definition." In endorsing a pro rata approach, Missouri follows the majority view that environmental contamination claims should be allocated among policy periods pro rata, in accordance with decisions by federal appellate courts and the highest state courts in New York, New Jersey, Massachusetts, Colorado, Idaho, Minnesota, Nebraska, New Hampshire, South Carolina and Vermont.

## Construction Defect Alert:

### *Legislation Requiring Coverage for Faulty Construction Does Not Apply Retroactively, Says South Carolina Supreme Court*

Striking down state legislative provisions, the South Carolina Supreme Court held that it would be unconstitutional to retroactively apply a statutory definition of the term "occurrence" to general liability policies that were negotiated prior to the statute's effective date. *Harleysville Mutual Ins. Co. v. State*, 2012 WL 5870799 (S.C. Nov. 21, 2012).

Courts have reached differing conclusions as to whether and under what circumstances losses arising out of faulty construction constitute a covered "occurrence" under general liability policies. *See* April 2010 Alert. Last year, the South Carolina Supreme Court weighed in on the issue, ruling that faulty workmanship was not an occurrence where the resulting damage was a natural and expected

consequence of the faulty work rather than a fortuitous event. *Crossman Communities of North Carolina, Inc. v. Harleysville Mutual Ins. Co.*, 2011 WL 93716 (S.C. Jan. 7, 2011) (*see* February 2011 Alert). Applying this standard, the *Crossman* court concluded that the policyholder was not entitled to coverage for the construction claims at issue. Thereafter, South Carolina passed legislation requiring the term "occurrence" in commercial general liability insurance policies to include "property damage or bodily injury resulting from faulty workmanship, exclusive of the faulty workmanship itself." S.C. Code. Ann. § 38-61-70 (Supp. 2011). The legislation further provided that it applied "to any pending or future dispute over coverage … as to all commercial general liability insurance policies issued in the past, currently in existence, or issued in the future." After the legislation's enactment, the *Crossman* court, on rehearing, reversed course and found in favor of coverage.

In *Harleysville*, the Supreme Court considered whether the South Carolina statute was unconstitutional in whole or in part. The court concluded that the statute did not violate the separation of powers doctrine or the Equal Protection Clause. However, it found that the portion of the statute requiring retroactive application violated the Contract Clauses of the United States and South Carolina Constitutions. In so ruling, the court explained that the statute

did not merely clarify existing law, but rather "fundamentally change[d] the definition of occurrence" in insurance contracts and thus "substantially impair[ed] pre-existing contracts by materially changing their terms." The court further held that the retroactivity provision was neither necessary nor reasonable, and thus declared it unconstitutional. In light of this ruling, the act may only be applied to insurance policies executed on or after the statute's May 17, 2011 effective date.

## Voluntary Payments Alert:

### *Policy Clause Prohibiting Policyholder from Admitting Liability is Against Public Policy, Says Illinois Appellate Court*

Addressing a matter of first impression, an Illinois appellate court ruled that a voluntary payments provision, which prohibited the insured from admitting liability without the insurer's consent, was unenforceable. *Illinois State Bar Assoc. Mut. Ins. Co. v. Frank M. Greenfield and Assocs., P.C.*, 2012 WL 5471875 (Ill. App. Div. Nov. 9, 2012).

By way of background, the case arose from a drafting error committed by an attorney in connection with the preparation of a will. When the attorney realized his mistake, he immediately notified the beneficiaries of the will. The beneficiaries then filed a malpractice suit against the attorney. The attorney's malpractice insurer denied a defense, contending that the attorney had forfeited his policy benefits by admitting wrongdoing to the beneficiaries without the insurer's consent or knowledge. The insurer filed a declaratory judgment action seeking a ruling that it had no duty to defend the suit.

The trial court ruled in the attorney's favor, reasoning that his disclosure did not constitute an admission of liability and thus did not violate the voluntary payments provision. The court explained that the attorney's letter only recited facts and did not admit liability. Alternatively, the trial court concluded that even if the letter did constitute a breach of the policy, the insurer was not prejudiced by the breach and thus was not entitled to deny coverage on that basis.

The appellate court affirmed on different grounds. It held that the voluntary payments provision was unenforceable because it implicated the attorney's ethical obligations. The court stated, "we are uncomfortable with the idea of an insurance company advising an attorney of his ethical obligations to his clients, especially since, as in the case at bar, the insurance company may advise the attorney to disclose less information than the attorney would otherwise choose to disclose.… Accordingly, we find that a provision such as the one at issue here is against

public policy, since it may operate to limit an attorney's disclosure to his clients."

The appellate court ruling is unusual in that voluntary payment provisions are typically enforced as written, and frequently have been held to bar coverage even in the absence of prejudice to the insurer. The court's invalidation of the provision is distinguishable as based on the unique nature of the attorney-client relationship.

# Discovery Alert:

## *Court Orders Production of Proof-of-Claim Materials in New York City Asbestos Litigation*

In a discovery ruling that applies to all New York City Asbestos Litigation ("NYCAL"), a New York judge ordered plaintiffs to disclose materials submitted in connection with proofs of claims filed with asbestos-related bankruptcy trusts established pursuant to Section 524(g) of the Bankruptcy Code. *In re New York City Asbestos Litigation*, No. 40000/88 (Sup. Ct. N.Y. Cnty. Nov. 16, 2012). In so ruling, the court rejected plaintiffs' arguments that such information is confidential and/or protected by work product or attorney-client privilege. Rather, the court reasoned that the proof-of-claim materials are "material and necessary" to the defense of the action and "are analogous to documents produced in response to discovery or mandatory exhibits." In light of the ruling, plaintiffs are required to timely produce affidavits or other sworn statements, proofs of diagnosis, and claim certificates submitted with proofs of claims.

# Subrogation Alerts:

## *Two Courts Allow Excess Insurers to Assert Legal Malpractice Claims Against Policyholder Defense Counsel*

Although an excess insurer is generally equitably subrogated to the rights of its insured upon discharging a liability of its insured, courts have reached differing outcomes when considering whether an excess insurer may assert legal malpractice claims against a law firm hired by a primary insurer to represent an insured. Numerous courts have rejected such claims on various bases. *See, e.g., Querrey & Harrow, Ltd. v. Transcontinental Ins. Co.*, 861 N.E.2d 719 (Ind. App. 2007) (reasoning that subrogation constitutes an impermissible assignment of a legal malpractice claim); *Essex Ins. Co. v. Tyler*, 309 F. Supp.2d 1270 (D. Colo. 2004) (noting limitations on malpractice claims against attorneys by non-client third parties); *Continental Casualty Co. v. Pullman, Comley, Bradley & Reeves*, 929 F.2d 103 (2d Cir. 1991) (finding that allowing such claims would interfere with the attorney-client relationship with insured). In two recent decisions, however, Mississippi and Illinois courts have allowed excess insurers to pursue legal malpractice claims against a policyholder's defense counsel pursuant to the doctrine of equitable subrogation.

In *Great American E & S Ins. Co. v. Quintairos, Prieto, Wood & Boyer, P.A.*, 2012 WL 4945958 (Miss. Oct. 18, 2012), the Mississippi Supreme Court allowed an excess insurer to bring an equitable subrogation claim against the law firm retained to represent the policyholder in an underlying negligence action. The law firm, which had been hired by the primary insurer, failed to timely designate expert witnesses on behalf of the policyholder. This failure resulted in a substantially increased settlement of the case. The primary insurer tendered its policy limits, leaving the excess carrier responsible for any damages that exceeded the primary policy's limits. After the excess carrier settled the case,

it sued the law firm for malpractice. A Mississippi trial court dismissed the suit, finding an absence of an attorney-client relationship between the excess carrier and the law firm. The Mississippi Court of Appeals reversed, finding that the excess insurer could assert direct claims against the law firm, including those based on equitable subrogation. With respect to the direct malpractice claims, the appellate court reasoned that the excess insurer had sufficiently alleged an attorney-client relationship because the law firm had provided the excess insurer with "legal services" by forwarding status reports and settlement evaluations during the course of the underlying litigation. As to the equitable subrogation claim, the appellate court reasoned that because state law did not prohibit the assignment of legal malpractice claims, the assertion of such claims by subrogation should not be prohibited. The court further explained that in some instances (*e.g.*, where an attorney's malpractice results in a judgment in excess of primary policy limits), the excess carrier may be the only party with an incentive to pursue a malpractice claim against the policyholder's counsel.

The Mississippi Supreme Court affirmed in part and reversed in part. The court affirmed the equitable subrogation ruling for the reasons set forth by the appellate court. However, the court reversed the ruling as to the direct malpractice claims, concluding that the sharing of status reports, without more, does not create an attorney-client relationship.

In *ACE American Ins. Co. v. Sandberg, Phoenix & Von Gontard, PC.*, 2012 WL 4573340 (S.D. Ill. Oct. 2, 2012), an Illinois district court also allowed excess insurers to assert legal malpractice claims against the policyholder's counsel. There, the policyholder was sued in a product liability action which culminated in a substantial settlement. A settlement was reached immediately after the trial judge sanctioned the defendant-policyholder by striking all pleadings on the basis of counsel's discovery abuses. The excess insurers sued the policyholder's counsel, arguing that its misconduct and the resulting sanctions exponentially increased the costs of settling the litigation. The law

firm's motion to dismiss the claims was denied.

The court held that direct malpractice claims were viable because one of the excess carriers had also provided primary coverage to the policyholder, and in that respect had assumed control of the policyholder's defense and established an attorney-client relationship with the law firm. The court allowed the subrogation claims to proceed, predicting that the Illinois Supreme Court would allow an excess carrier to enforce duties owed by the attorney to the insured. In so ruling, the court distinguished cases in which courts have forbidden the *assignment* of legal malpractice actions, explaining that an assignee is typically a stranger to the attorney-client relationship who has suffered no injury from the lawyer's conduct, whereas an excess insurer may suffer injury as a direct result of the attorney's actions, as was the case here.

## *Subrogation Provision Does Not Entitle World Trade Center Leaseholders to Proceeds from Insurers' Settlement with Airlines, Says New York Court*

Ruling on cross-motions for summary judgment, a New York federal district court held that subrogation

provisions did not entitle policyholders to proceeds from their insurers' settlement with alleged tortfeasors unless the policyholders were able to demonstrate that they had legally recoverable tort damages that exceeded their insurance recovery. *In re September 11 Litigation*, 2012 WL 5954585 (S.D.N.Y. Nov. 27, 2012).

Following the World Trade Center attack, numerous insurers made payments to leaseholders of the property totaling approximately $4.1 billion. The insurers then brought subrogation claims against various alleged tortfeasors, including airline companies and other aviation entities, seeking to recover their insurance payments to the leaseholders. The subrogation claims were ultimately settled for $1.2 billion, which was pro rated among the insurers. Following the settlement, the leaseholders filed a declaratory judgment action against the insurers alleging that the policies' subrogation provisions entitled them to priority with respect to a portion of the settlement proceeds.

The dispute centered on interpretation of subrogation provisions in two sets of policies. One provision required settlements obtained by subrogation to be distributed first to the policyholder "for any uninsured loss or damage." The other provision required subrogation proceeds to be divided according to "provable loss." The leaseholders argued that the language in each provision granted them priority to the insurers' settlement proceeds until the leaseholders had recovered all of their actual losses. In contrast, the insurers contended that the subrogation clauses entitled the leaseholders to settlement proceeds only if they had "legally recoverable tort damages exceeding [their] insurance recovery." The court sided with the insurers and denied the leaseholders' summary judgment motion, finding that "uninsured loss or damage" and "provable loss" referred to damages recoverable in a tort lawsuit, not to all categories of loss and damage. The court also denied the insurers' motion, noting that it "remain[ed] possible" that the leaseholders would be able to satisfy the subrogation provision requirements. Industrial Risk Insurers, one of the defendant insurers in the suit, is represented by Simpson Thacher partner Barry R. Ostrager.

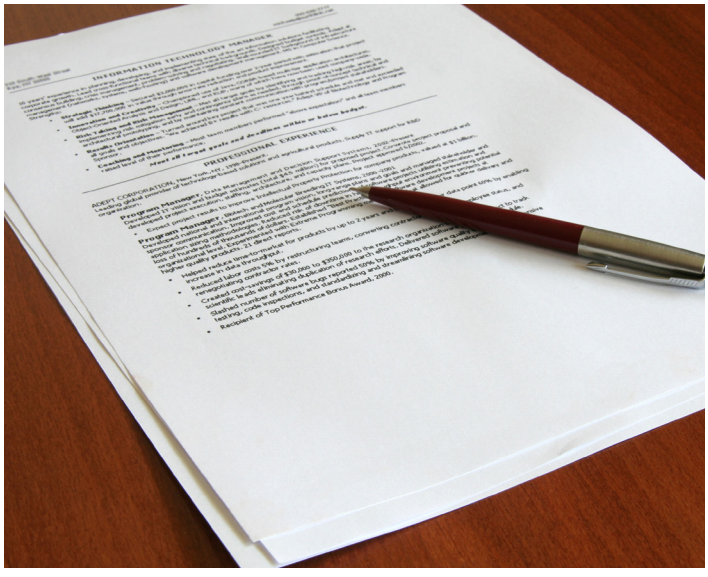
The decision reinforces the principle that a policyholder may not invoke a subrogation clause in order to recover more from its insurer than it could recover had it filed its own suit directly against a third-party tortfeasor.

## Broker Alert:

### *Policyholder's Failure to Read Policy Does Not Preclude Negligence Claim Against Broker*

New York's highest court declined to dismiss negligence and breach of contract claims against an insurance broker, reasoning that the policyholder's failure to review the policy did not automatically preclude such claims. *American Bldg. Supply Corp. v. Petrocelli Grp., Inc.*, 2012 WL 5833969 (N.Y. Nov. 19, 2012).

The policyholder retained an insurance broker to procure general liability insurance that would cover, among other things, bodily injury sustained by the policyholder's employees. The broker renewed a prior policy which contained a "cross-liability" exclusion barring coverage for injuries to employees.



The policyholder failed to review the policy prior to issuance. During the policy period, an employee sustained injuries at the policyholder's facility. The insurer denied coverage on the basis of the cross-liability exclusion and a New York appellate court ultimately held that the insurer had no duty to defend or indemnity the policyholder. The policyholder then sued the broker alleging a failure to procure requested coverage. The trial court denied the broker's motion to dismiss, reasoning that a question of fact existed as to whether the policyholder had made a specific request for coverage. The appellate court reversed. The appellate court held that regardless of disputed factual issues pertaining to the policyholder's coverage requests, claims against the broker were barred by the policyholder's failure to review the policy. The New York Court of Appeals granted leave to appeal and reversed the appellate court decision.

Under New York law, a negligence or breach of contract claim may stand against an insurance broker where the policyholder made a specific coverage request to the broker and the broker failed to obtain such coverage. However, New York law is unclear as to whether such claims are barred where, as here, the policyholder fails to review and/or object to the policy upon its receipt. While some appellate courts have held that once a policyholder has received a policy, it is "presumed to have read and understood it and cannot rely on the broker's word that the policy covers what is requested," other appellate courts have ruled that "receipt and presumed reading of the policy does not bar an action for negligence against the broker." Siding with the latter view, the New York Court of Appeals ruled that where a policyholder has allegedly made a specific request for a particular type of coverage to its broker, the policyholder's failure to read the policy does not automatically bar a negligence claim against the broker.

# Drywall Alert:

## *Virginia Supreme Court Enforces Pollution Exclusion to Bar Coverage for Drywall-Related Claims*

Last month, the Virginia Supreme Court ruled that four exclusions in a property policy each unambiguously bar coverage for damages arising out of the installation of defective drywall. *Travco Ins. Co. v. Ward*, 2012 WL 5358705 (Va. Nov. 1, 2012). Our July/August 2010 Alert reported the Virginia federal district court decision holding that coverage was precluded by exclusions for pollution, latent defects, faulty materials and rust/corrosion. *Travco Ins. Co. v. Ward*, 2010 WL 2222255 (E.D. Va. June 3, 2010). On appeal, the Fourth Circuit noted that this important issue of law was undecided in Virginia and thus certified to the Virginia Supreme Court a question asking whether drywall-related damages were excluded under the four exclusions at issue. *Travco Ins. Co. v. Ward*, 2012 WL 666230 (4th Cir. Mar. 1, 2012) (*see* April 2012 Alert). Answering the certified question in the affirmative, the Virginia Supreme Court noted that each exclusion was unambiguous and applied squarely to the bodily injury and property damage allegedly caused by the

"off-gassing" of chemicals from the drywall. *Travco* is the first state supreme court to rule on this issue and the decision joins a growing number of rulings in Virginia and other jurisdictions holding that drywall-related claims fall within the scope of a broadly-worded pollution exclusion. *See Dragas Mgmt. Corp. v. Hanover Ins. Co.*, 78 F. Supp.2d 766 (E.D. Va. 2011); *Nationwide Mut. Ins. Co. v. The Overlook, LLC*, 785 F. Supp.2d 502 (E.D. Va. 2011); *Proto v. Futura Grp., LLC*, 2011 WL 8964928 (Vir. Cir. Ct. May 6, 2011); *Evanston Ins. Co. v. Harbor Walk Dev., LLC*, 814 F. Supp.2d 635 (E.D. Va. 2011); *QBE Ins. Corp. v. Estes Heating & Air Conditioning, Inc.*, 2012 WL 413968 (S.D. Ala. Feb. 9, 2012); *Granite State Ins. Co. v. American Bldg. Materials, Inc.*, 2011 WL 6025655 (M.D. Fla. Dec. 5, 2011); *Lopez v. Shelter Ins. Co.*, 833 F. Supp.2d 613 (S.D. Miss. 2011); *Ross v. C. Adams Construction & Design, LLC*, 70 So.3d 949 (La. Ct. App. 2011).

# Hurricane Alert:
## *Navigating the Insurance Implications of Superstorm Sandy*

In the weeks since Sandy struck the east coast of the United States, estimates of property damage, business interruption expenses and other related losses have exceeded $70 billion, with insured losses estimated to be in the $25 billion range. As hundreds of thousands of homeowners, businesses and other entities turn to their insurers for reimbursement of hurricane-related losses, several key coverage issues are likely to arise.

### Business Interruption Coverage

Widespread power outages, transportation closures and evacuations resulted in enormous revenue losses to insured businesses. Whether such losses are covered under business interruption provisions will depend primarily on the particular cause and nature of the loss as well as the applicable policy language. A critical inquiry in this context will be whether the interruption of business activities was caused by physical damage to the insured's property or by some other factor, such as damage to neighboring or nearby property, government action (*e.g.*, evacuation), or other intangible factors (*e.g.*, loss of electricity, decrease in tourism appeal). Where there has been no physical property damage, insurers may have a valid basis for denying coverage for business interruption losses. *See, e.g., Pentair, Inc. v. American Guar. & Liab. Ins. Co.*, 400 F.3d 613 (8th Cir. 2005) (loss of power in factories, resulting in failure to manufacture products does not constitute a "direct physical loss"); *Roundabout Theatre Co. v. Continental Casualty Co.*, 302 A.D.2d 1, 751 N.Y.S.2d 4 (1st Dep't 2002) (no coverage under business interruption policy where street closure forced theater to cancel performances); *Ramada Inn Ramogreen, Inc. v. Travelers Indem. Co. of Am.*, 835 F.2d 812 (11th Cir. 1988) (no coverage for income loss caused by decrease in hotel room occupancy after loss of restaurant where hotel was not physically damaged and did not suspend operations); *Keetch v. Mutual of Enumclaw Ins. Co.*, 66 Wash. App. 208, 831 P.2d 784 (Wash. Ct. App. 1992) (no coverage where motel suffered loss of business after volcano eruption; decline in "physical attractiveness" of property was insufficient physical damage since motel was able to stay open).

Additionally, business interruption coverage may be unavailable if a policyholder is unable to establish a causal connection between the damage to property (or other covered event) and the loss in business revenue. *See Arthur Andersen LLP v. Federal Ins. Co.*, 416 N.J. Super. 334, 3 A.3d 1279 (N.J. App. Div. 2010) (post-September 11 losses not covered under business interruption provision where policyholder failed to allege causation between property damage and its subsequent loss in revenue) (*see* November 2010 Alert); *United Airlines, Inc. v. Insurance Co. of the State of Pennsylvania*, 385 F. Supp.2d 343 (S.D.N.Y. 2005) (rejecting coverage for $1.2 billion in business interruption coverage after World Trade Center attack because amount of recovery sought, based on total shutdown of U.S. aviation system, bore

no relation to the actual property damage suffered by the policyholder at its World Trade Center ticket counter), *aff'd*, 439 F.3d 128 (2d Cir. 2006); *Dickie Brennan & Co., Inc. v. Lexington Ins. Co.*, 636 F.3d 683 (5th Cir. 2011) (no business interruption coverage for losses incurred as a result of evacuation because policyholder failed to establish a causal link between "damage to property other than at the described premises" and the issuance of the evacuation order, as required by the policy).

Business interruption coverage disputes may also focus on the proper method of calculating covered losses. Litigation in this context has centered on whether business interruption loss should be calculated based only on a policyholder's pre-interruption sales figures, or whether post-interruption sales figures should be considered as well. The method of loss calculation takes on heightened importance in situations in which a policyholder experiences dramatically increased sales revenues following a catastrophe due to the elimination of its competitors. *See Catlin Syndicate Ltd. v. Imperial Palace of Mississippi*, 600 F.3d 511 (5th Cir. 2010) (policyholder's recovery could be based only on its lower, pre-hurricane sales, rather than on post-hurricane sales that reflected elimination of policyholder's competitors) (*see* May 2010 Alert); *Consolidated Cos., Inc. v. Lexington Ins. Co.*, 616 F.3d 422 (5th Cir. 2010) (business interruption losses should be based on the policyholder's historical sales figures, not on a scenario in which a disaster struck but did not damage the policyholder's facility); *Finger Furniture Co. v. Commonwealth Ins. Co.*, 404 F.3d 312 (5th Cir. 2005) ("The strongest and most reliable evidence of what a business would have done had catastrophe not occurred is what it had been doing in the period just before the interruption."). Some policies may include explicit policy language precluding the consideration of post-catastrophe sales spikes in calculating business interruption losses. The calculation of business interruption coverage may also be contested where a policyholder is unable to restart business in its prior location. *See Retail Brand Alliance, Inc. v. Factory Mutual Ins. Co.*, 489 F. Supp.2d 326 (S.D.N.Y. 2007) (in wake of the September 11th attack, business interruption coverage extends only until policyholder builds "reasonably equivalent stores in a reasonably equivalent location," not for the hypothetical time frame it would take to rebuild in a new "World Trade Center" complex; extending business interruption coverage until a business is restored to its prior "profit-earning potential" would be "nonsensical").

## Questions of Causation: Wind vs. Flood Damage

In order to obtain property insurance under an all risk or named perils policy, policyholders typically bear the burden of establishing that the loss was caused by a covered risk. In the storm-damage context, proof of causation may present several difficulties for policyholders. Damage may be caused by a combination of covered and uncovered risks, or may result from a sequence of events, only some of which are within the scope of policy coverage. Additionally, the cause of damage may be difficult or impossible to ascertain where properties have become inaccessible for inspection due to evacuation orders or other practical obstacles. Although the latter issue has already been addressed by several states (by way of executive orders or initiatives that relax the standards for inspection, proof of loss and other policy requirements), the legal

issue of causation may nonetheless arise in numerous post-Sandy coverage disputes.

When a loss is caused by both covered and excluded perils, most courts apply the efficient proximate cause doctrine, which holds that there is coverage only if the covered peril is the predominant cause of the loss or damage. In coverage litigation arising out of hurricane-related damage, this analysis frequently gives rise to a wind vs. water debate. The attribution of loss to wind vs. water is critical given that most property policies cover wind-related damage but exclude losses arising from flooding. The wind vs. flood analysis may also be decisive in determining whether claims are covered by private insurance as opposed to the National Flood Insurance Program, where applicable.

Resolution of causation issues may implicate interpretation of policy provisions relating to "ensuing loss" and/or "anti-concurrent causation." Ensuing loss clauses, which act as exceptions to property insurance exclusions, may operate to provide coverage when as a result of an excluded peril, a covered peril arises and causes damage. However, in order for the ensuing loss clause to apply, there must be a distinct, new, covered peril. In addition, courts may be unlikely to find coverage pursuant to an ensuing loss clause where the damage at issue is otherwise expressly excluded by a particular policy provision. *See Fiess v. State Farm Lloyds*, 202 S.W.3d 744 (Tex. 2006). Storm-related damage may also be outside the scope of coverage pursuant to an "anti-concurrent causation clause." Courts have enforced clearly worded anti-concurrent provisions to bar coverage when an excluded peril (such as water) and a covered peril (such as wind) combine to damage personal property. *See Leonard v. Nationwide Mutual Ins. Co.*, 499 F.3d 419 (5th Cir. 2007), *cert. denied*, 128 S. Ct. 1873 (2008); *South Carolina Farm Bureau Mutual Ins. Co. v. Durham*, 380 S.C. 506, 671 S.E.2d 610 (S.C. 2009); *ARM Properties Mgmt. Grp. v. RSUI Indem. Co.*, 2010 WL 4386787 (5th Cir. Nov. 5, 2010).

**Water Damage Exclusions**

Water damage exclusions, common in many property policies, may give rise to coverage litigation where heavy rains, other moving water sources or accumulated areas of water are the primary cause of property damage. Although specific policy language will ultimately dictate courts' decisions in this context, insurance coverage litigation arising out of Hurricane Katrina provides support for insurers seeking to deny coverage on the basis of water damage exclusions under a variety of circumstances. *See In re Katrina Canal Breaches Litig.*, 495 F.3d 191 (5th Cir. 2007) (rejecting distinction between natural and non-natural causes in applying a flood exclusion and holding that losses caused by the flooding of breached levees were excluded); *Sher v. Lafayette Ins. Co.*, 988 So.2d 186 (La. 2008) (flood exclusion unambiguously excludes damage caused by water that flowed through levees); *Corban v. United Servs. Auto. Ass'n*, 20 So.3d 601 (Miss. Oct. 8, 2009) (rejecting insured's argument that the water damage exclusion should not apply because the damage at issue was caused by "storm surge," which was not specifically listed in exclusion).

**Replacement Costs and Actual Cash Value**

As business and property owners begin the repair and rebuilding process, policyholders and insurers may disagree as to the proper method of calculating property valuations. Property policies may allow a policyholder to obtain reimbursement for replacement costs (often defined as the cost to replace destroyed property with property of "like kind and quality") and/or actual cash value ("ACV") (often held to be the depreciated value of the destroyed property). In ascertaining the replacement cost or ACV of an insured property, questions may arise as to the relevance of certain economic factors. For example, policyholders may seek inflated replacement cost assessments where post-hurricane regulations impose more costly building requirements. Such arguments have been rejected by courts in analogous contexts. *See SR Int'l*

*Bus. Ins. Co., Ltd. v. World Trade Center Props., LLC*, 2006 WL 3073220 (S.D.N.Y. Oct. 31, 2006), *opinion clarified by*, 2007 WL 519245 (S.D.N.Y. Feb. 16, 2007) (holding that replacement cost recovery is limited to the amount it would cost to rebuild the World Trade Center "precisely" as it existed on September 11, 2001 and rejecting policyholder's contention that replacement costs include the additional expenses necessary to adapt the new structure's design to the "changed legal, physical, and political environment of post-9/11 New York"); *SR Int'l Bus. Ins. Co., Ltd. v. World Trade Center Props., LLC*, 445 F. Supp.2d 320 (S.D.N.Y. 2006) ("Hypothetical replacement cost is an estimate of the costs of reproducing the destroyed property as it stood at the time of loss, not a calculation of the projected cost of the actual replacement property.").

**Reinsurance Coverage**

Although primary insurers are likely to bear the brunt of Sandy's insurable losses, hundreds of millions of dollars of reinsurance proceeds may also be at stake. As claims against primary insurers settle or enter litigation, disputes between ceding insurers and reinsurers may follow. Given Sandy's unusually long duration (more than 72 hours) and extensive geographic reach (more than 1,000 miles), reinsurance disputes may turn on whether the storm constituted a single occurrence or multiple occurrences under reinsurance policies. Similarly, a critical issue may relate to interpretation of an "hours" clause, which limits the duration of an occurrence to a fixed number of hours. These and other reinsurance disputes will all likely implicate "follow the settlements" and/or "follow the fortunes" provisions, which limit a reinsurer's ability to challenge a primary insurer's reasonable, good faith settlement and litigation decisions.

In months and years to come, the widespread destruction caused by Sandy may give rise to a host of other coverage issues, including interpretation of sue and labor clauses, notice provisions and various policy-specific exclusions. We will continue to keep you updated on significant developments in this context.

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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"Opponents acting for policyholders admit that Simpson Thacher is the gold standard for representing insurance companies across the USA in bet-the-company cases."

*—Chambers USA 2012*

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