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INSURANCE LAW ALERT

JANUARY 2014

This Alert discusses recent decisions relating to a policyholder's failure to comply with a voluntary payment provision. In addition, we report on rulings addressing excess insurance coverage, the availability of general liability coverage for computer data breaches and whether an attorney-client relationship exists between a policyholder's defense counsel and the insurer funding the defense. Finally, we discuss a United States Supreme Court decision finding that there is no federal court jurisdiction under CAFA for a suit brought by a state attorney general. Best wishes to you in the New Year!

- ***Failure to Obtain Insurer Consent To Settlement Precludes Coverage, Says Fourth Circuit***

  The Fourth Circuit ruled that under Maryland and Tennessee law, a policyholder forfeits coverage by breaching a voluntary payment provision, regardless of prejudice to the insurer. *Perini/Tompkins Joint Venture v. Ace American Ins. Co.*, 738 F.3d 95 (4th Cir. 2013). *Click here for full article*

- ***Indiana Appellate Court Rules That Insurer Did Not Abandon Policyholder and Thus Could Deny Coverage on Basis of Voluntary Payment Provision***

  An Indiana appellate court ruled that despite its initial refusal to defend, an insurer fulfilled its contractual obligations to a policyholder and properly denied coverage under a voluntary payment provision because it did not consent to the settlement of the underlying case. *Klepper v. Ace American Ins. Co.*, 999 N.E.2d 86 (Ind. Ct. App. 2013). *Click here for full article*

- ***Connecticut Appellate Court Rules That Data Breach Does Not Constitute "Personal Injury" Under General Liability Policy***

  A Connecticut appellate court ruled that claims arising out of the accidental loss of computer data did not fall within the scope of general liability coverage. *Recall Total Information Mgmt., Inc. v. Federal Ins. Co.*, No. AC34716 (Conn. App. Ct. Jan. 14, 2014). *Click here for full article*

- ***Pro Rata Allocation Limits Application of Horizontal Exhaustion Requirement, Says Maryland Court***

  A Maryland federal district court ruled that although Maryland law requires horizontal exhaustion of primary policies in order to access excess coverage, excess coverage for particular years may be available if the primary policies for those years have been exhausted pursuant to a pro rata allocation. *National Union Fire Ins. Co. v. Porter Hayden Co.*, 2014 WL 43506 (D. Md. Jan. 2, 2014). *Click here for full article*

- ***Oklahoma Court Rules That Excess Insurers Are Not Required to "Drop Down" When Primary Insurer Is Insolvent***

  An Oklahoma federal district court ruled that excess and umbrella carriers did not have to "drop down" to defend or indemnify a policyholder in underlying asbestos litigation when the underlying primary insurer was insolvent. *Canal Ins. Co. v. Montello, Inc.*, 2013 WL 6732658 (N.D. Okla. Dec. 19, 2013). *Click here for full article*

- ***U.S. Supreme Court Rules That Suit Brought by State Attorney General is Not Subject to Federal Jurisdiction Under CAFA***

  The United States Supreme Court ruled that a price fixing lawsuit brought by a state attorney general as the sole plaintiff does not constitute a class action for the purposes of triggering federal jurisdiction under the Class Action Fairness Act. *Hood v. AU Optronics Corp.*, 134 S. Ct. 736 (U.S. 2014). *Click here for full article*

- ***No Attorney-Client Relationship Between Insurer and Policyholder's Defense Counsel, Says Oregon Court***

  An Oregon federal district ruled that there was no attorney-client relationship between an insurer and its policyholder's counsel, despite the insurer's funding of the policyholder's defense of underlying environmental litigation. *Evraz Inc. v. Continental Ins. Co.*, 2013 WL 617839 (D. Or. Nov. 21, 2013). *Click here for full article*

VOLUNTARY PAYMENTS ALERTS:

Failure to Obtain Insurer Consent To Settlement Precludes Coverage, Says Fourth Circuit

The Fourth Circuit ruled that under Maryland and Tennessee law, a policyholder forfeits coverage by breaching a voluntary payment provision, regardless of prejudice to the insurer. *Perini/Tompkins Joint Venture v. Ace American Ins. Co.*, 738 F.3d 95 (4th Cir. 2013).

Perini/Tompkins Joint Venture ("PTJV"), a management company, was sued for breach of contract and breach of fiduciary duty in connection with a construction project. PTJV settled the suit without seeking consent from Ace American Insurance Company, its general liability insurer. Following settlement, PTJV sought reimbursement from Ace. Ace denied coverage based on PTJV's breach of the insurance contract by failing to obtain its consent to settlement. In ensuing coverage litigation, a Maryland federal district court granted Ace's summary judgment motion on the issue, finding that PTJV's breach resulted in a loss of coverage. The Fourth Circuit affirmed.

There was no dispute that PTJV failed to comply with the voluntary payment clause, which required insurer consent to settlement, and the "no action clause," which conditioned coverage on compliance with all policy terms. The central issue in dispute was whether Ace was required to establish prejudice to deny coverage on these bases. The court held that prejudice was not required, reasoning that the policy provisions were conditions precedent to coverage. The court rejected PTJV's reliance on Maryland statutory law requiring an insurer to show actual prejudice to deny coverage based on untimely notice or a policyholder's lack of cooperation. *See* Md. Code Ann. § 19-110. The court held that the statute did not apply to coverage denials based on violations of condition precedents to coverage, as was the case here. Similarly, the court rejected the notion that Maryland common law requires a prejudice showing, explaining that "an insured's failure to obtain the insurer's prior consent to a settlement does not *ever* require prejudice primarily because—whether statutory-based or common law-based—an insurer would always have 'the impossible burden … of showing collusion or demonstrating, after the fact, the true worth of the settled claim.'" In any event, the court noted that even if prejudice were required, Ace suffered prejudice under Maryland and Tennessee law because it was not notified of the claims until after settlement.

Ace American joins a growing number of decisions in which courts have barred coverage on the basis of a voluntary payment provision without requiring the insurer to establish prejudice. *See* February 2013 Alert.

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Indiana Appellate Court Rules That Insurer Did Not Abandon Policyholder and Thus Could Deny Coverage on Basis of Voluntary Payment Provision

An Indiana appellate court ruled that despite its initial refusal to defend, an insurer fulfilled its contractual obligations to a policyholder and properly denied coverage under a voluntary payment provision where the insurer had not consented to the settlement of the underlying case. *Klepper v. Ace American Ins. Co.*, 999 N.E.2d 86 (Ind. Ct. App. 2013).

A distillery operator was sued in a class action alleging nuisance, negligence, trespass and illegal dumping based on the release of ethanol fumes into the environment. The operator tendered the claims to Ace, which mistakenly classified the suit as an underage drinking matter and "closed its file." More than a year later, when Ace was advised that the suit did not involve allegations of underage drinking, it agreed to contribute to the defense under a reservation of rights. Ace reimbursed another insurer (XL Insurance) for a portion of the previously-incurred defense costs and agreed to continue contributing to the defense. During mediation of the underlying dispute, Ace was asked to contribute $1 million toward settlement. Ace refused and offered $250,000. Thereafter, Ace attended a second round of mediation, but left before it was over. In Ace's absence, a settlement was reached between the distillery operator, the plaintiff class, and XL. The agreement required the operator to pay $1.2 million and XL to pay $1 million, and contemplated a $3 million payment by Ace "to the extent that the damages fall within the scope of ACE['s] Commercial General Liability Policy." A court approved the settlement as fair and reasonable. Thereafter, the plaintiff class, as assignee of the operator's claims, sued Ace, alleging bad faith and demanding payment of the $3 million.

Plaintiffs alleged that Ace had breached the insurance contract by "abandoning" its insured. The court held that it did not. It explained that despite its initial wrongful closing of the case, Ace did not breach its duty to defend because the distillery operator was represented at all times in the underlying class action (even if by XL rather than Ace) and that "at the end of the day, Ace ultimately contributed $167,965.17 toward [the] defense." Similarly, the court concluded that Ace did not breach the contract by failing to negotiate settlement in good faith, observing that Ace made a $250,000 offer during mediation, and in so doing reasonably relied on certain coverage defenses. Having determined that Ace did not breach its duty to defend, the court concluded that it was entitled to rely on the voluntary payment provision to deny coverage.

Notwithstanding the finding of no breach, the court declined to dismiss the bad faith claims against Ace. The court explained that even in the absence of a contractual breach, punitive damages may be imposed against an insurer on the basis of tort (rather than contract) claims. As reported in our January 2013 Alert, a California court employed similar reasoning and declined to dismiss a bad faith claim despite the insurer's defense and indemnification of its policyholder. *See Lehman Commercial Paper, Inc. v. Fidelity Nat'l Title Ins. Co.*, 2013 WL 26741 (C.D. Cal. Jan. 2, 2013).

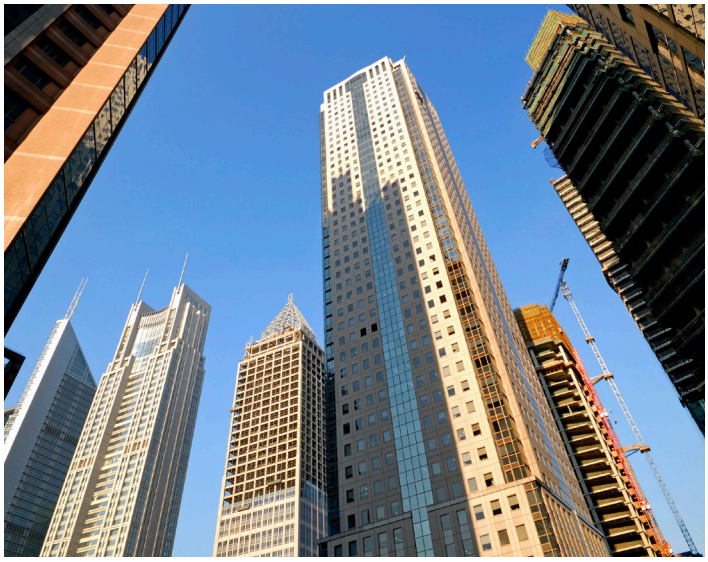
Coverage Alert:
Connecticut Appellate Court Rules That Data Breach Does Not Constitute "Personal Injury" Under General Liability Policy

A Connecticut appellate court ruled that claims arising out of the accidental loss of computer data did not fall within the scope of general liability coverage. *Recall Total Information Mgmt., Inc. v. Federal Ins. Co.*, No. AC34716 (Conn. App. Ct. Jan. 14, 2014).

IBM retained Recall Total Information Management

to transport and store electronic media. Recall, in turn, contracted with Executive Logistics to transport the electronic media. Executive Logistics obtained general and umbrella liability coverage naming Recall as an additional insured. During the transportation of the media, a cart of computer tapes fell out of the back of a van. The tapes, which were never recovered, contained employment data for approximately 500,000 IBM employees. Following the incident, IBM undertook various mitigation measures in order to protect against identity theft or other harm, and Recall agreed to reimburse IBM $6 million for its mitigation expenses. Recall then sought indemnification from Executive Logistics, which filed claims with its insurers. The insurers denied coverage, Recall and Executive Logistics eventually settled, and Executive assigned its policy rights to Recall. Recall filed suit against the insurers for breach of contract. A Connecticut trial court granted the insurers' summary judgment motion, finding that Recall's losses were not covered under the policies. The appellate court affirmed.

On appeal, Recall argued two main points: (1) that the insurers breached their duty to defend and thus waived their coverage defenses; and (2) that the loss of computer tapes constituted a personal injury under the liability policies. The court rejected both contentions. The court concluded that there was no duty to defend because no "suit" had been filed. The court explained that neither IBM's monetary demands against Recall nor the parties' ongoing settlement negotiations were the equivalent of a "suit." With respect to coverage under the policies, the court held that the loss of computer tapes did not constitute "personal injury," defined as injury caused by "electronic, oral, written or other publication of material that … violates a person's right to privacy." The court explained that because there was no "publication" of the lost computer data, there was no personal injury coverage. The court stated: "[a]s the complaint and affidavits are entirely devoid of facts suggesting that the personal information actually was accessed, there has been no publication." Additionally, the court dismissed the notion that there was a "presumptive invasion of privacy" because the incident triggered certain obligations under state notification statutes. Recall argued that because New York and Connecticut notification statutes required IBM to notify its affected employees of the data loss, it necessarily followed that there had been an invasion of privacy. The court disagreed, stating that "merely triggering a notification statute is not a substitute for a personal injury."



With computer data loss coverage disputes on the rise, *Recall* is instructive for insurers on several fronts. First, the decision serves as a reminder that a policyholder's mitigation measures, even when undertaken in response to monetary demands or settlement negotiations, do not constitute a "suit" giving rise to a duty to defend. Second, the ruling illustrates that data breaches, standing alone (*i.e.*, without accompanying allegations of consequential injury resulting from "publication" of the material) may be outside the scope of personal injury coverage. Some courts have also found that the loss of computer data does not constitute "property damage" under a general liability policy.

EXCESS COVERAGE ALERTS:

Pro Rata Allocation Limits Application of Horizontal Exhaustion Requirement, Says Maryland Court

A Maryland federal district court ruled that although Maryland law requires horizontal exhaustion of primary policies in order to access excess coverage, excess coverage for particular years may be available if the primary policies for those years have been exhausted pursuant to a pro rata allocation. *National Union Fire Ins. Co. v. Porter Hayden Co.*, 2014 WL 43506 (D. Md. Jan. 2, 2014).

Porter Hayden sought coverage under primary and excess policies for asbestos-related claims. The excess insurers sought a legal ruling that under Maryland's horizontal exhaustion rule, all available primary insurance must be exhausted before any excess carrier is required to pay for loss. In contrast, Porter Hayden argued that the horizontal exhaustion rule must be applied within the context of pro rata allocation, under which each insurer is only responsible for its pro rata share of loss. The court agreed. The court explained that because pro rata allocation limits each insurer's responsibility to its time on the risk, primary policies may be exhausted at different times, and "as a result, certain excess policies respond sooner than others." In so ruling, the court rejected the notion that because certain operations claims were not subject to aggregate limits in the primary policies, excess insurance could not be triggered for those years.

Porter Hayden leaves several questions unanswered. The court declined to consider whether the policy language of particular excess policies explicitly required the exhaustion of all primary coverage, or instead, listed specific primary policies to be exhausted. In addition, the court declined to rule on the classification of claims as "operations" or "completed operations," a determination that could likely have significant implications in the exhaustion context.

Oklahoma Court Rules That Excess Insurers Are Not Required to "Drop Down" When Primary Insurer is Insolvent

An Oklahoma federal district court ruled that excess and umbrella carriers did not have to "drop down" in the place of an insolvent primary insurer to defend or indemnify a policyholder in underlying asbestos litigation. *Canal Ins. Co. v. Montello, Inc.*, 2013 WL 6732658 (N.D. Okla. Dec. 19, 2013).

Home Insurance Company provided primary insurance for Montello, a distributor of asbestos-containing products. When it became apparent that Home would be unable to fulfill its contractual obligations, Montello sought defense and indemnity from its excess and umbrella insurers, whose coverage sat above Home's primary policies. Home became insolvent before paying its underlying limits, and in fact before any claims had been paid on Montello's behalf. In this declaratory judgment action, the excess and umbrella insurers sought a ruling regarding their rights and liabilities to Montello.

The Oklahoma Supreme Court has not addressed whether excess insurers are required to drop down in the face of an insolvent primary carrier. The district court predicted that Oklahoma law would follow the

majority of jurisdictions to find that an excess insurer is not obligated to assume an insolvent primary insurer's defense or indemnity obligations, absent policy language indicating the intent to do so. The court reasoned that excess policies are triggered only after primary limits have been exhausted, and that requiring an excess insurer to provide coverage prior to exhaustion "would improperly reallocate the risks that the parties had freely agreed to and had been compensated to assume." In so ruling, the court rejected several arguments asserted by Montello in support of its "drop down" position: (1) that the insolvency of Home was an "occurrence" that was covered by the excess policies: (2) that the "ultimate net loss" policy provision contemplated a primary insurer's non-payment by virtue of insolvency; (3) that a primary insurer's inability to pay a loss is equivalent to exhaustion by payment of loss; and (4) that the excess policies were ambiguous and should thus be interpreted in favor of coverage. The court further rejected Montello's attempt to obtain coverage pursuant to an "umbrella clause" or "other insurance" policy provision.

Montello illustrates the importance of policy language in this context. The court explicitly distinguished provisions requiring exhaustion by "payment of loss" (as was the case here) with excess clauses that provide indemnification for amounts "recoverable" or "collectible" from underlying insurers. In some cases, courts have interpreted the latter language to allow for excess recovery where the policyholder is unable to collect from its primary carriers. Significantly, the court did not address whether Montello's payment of primary policy limits would satisfy the excess policies' exhaustion requirement, noting that "Montello has not expended any of its own funds in the settlement or payment of claims sufficient to exhaust the applicable limits of a single Home policy." Other courts have concluded that an exhaustion requirement is not satisfied simply because a policyholder's liabilities reach excess attachment levels. *See* June 2013 Alert. Similarly, courts have rejected attempts to obtain excess coverage where a policyholder "pays the gap" between a below limits policy settlement and primary policy limits. *See* October 2012 Alert.

Jurisdictional Alert:

U.S. Supreme Court Rules That Suit Brought by State Attorney General is Not Subject to Federal Jurisdiction Under CAFA

The United States Supreme Court ruled that a price fixing lawsuit brought by a state attorney general as the sole plaintiff does not constitute a class action for the purposes of triggering federal jurisdiction under the Class Action Fairness Act ("CAFA"). *Hood v. AU Optronics Corp.*, 134 S. Ct. 736 (U.S. 2014).

The state of Mississippi sued AU Optronics in state court alleging violations of state antitrust and consumer statutes. AU Optronics sought to remove the case to federal district court on the basis that the suit constituted a "class action" or "mass action" under CAFA. A Mississippi federal district court held that the suit constituted a "mass action" because it was an action in which "monetary relief claims of 100 or more persons are proposed to be tried jointly on the ground that the plaintiffs' claims involve common questions of law or fact." However, the district court nonetheless remanded the case to state court pursuant to CAFA's

"general public exception," which excludes certain statutory-based lawsuits from the "mass action" definition. The Fifth Circuit reversed. It agreed with the district court that the suit was a mass action, but disagreed as to applicability of the general public exception. The United States Supreme Court granted certiorari and reversed.

The Supreme Court focused on the language of CAFA. In particular, the court reasoned that mass actions were defined to include suits brought by "100 or more persons" rather than "100 or more named or unnamed real parties in interest." The Court noted that had Congress intended CAFA to include the latter (*e.g.*, suits brought by a state attorney general on

behalf of a state alleging harm on behalf of unnamed state citizens), "it easily could have drafted language to that effect." In so ruling, the Court noted that the primary concern underlying the enactment of CAFA related to federal jurisdiction over class actions, and that the mass action provision "functions largely as a backstop to ensure that CAFA's relaxed jurisdictional rules cannot be evaded by a suit that names a host of plaintiffs rather than using the class device." As noted in previous Alerts, attempts by class plaintiffs to circumvent CAFA in order avoid federal court jurisdiction have been rejected. *See Standard Fire Ins. Co. v. Knowles*, 133 S. Ct. 1345 (U.S. 2013) (U.S. Supreme Court rules that class action plaintiff cannot escape federal jurisdiction under CAFA by agreeing to seek less than statutory minimum in damages) (April 2013 Alert); *Cappuccitti v. DirecTV, Inc.*, 623 F.3d 1118 (11th Cir. 2010) (Eleventh Circuit vacates an earlier ruling that required at least one class member to allege an amount in controversy over $75,000) (November 2010 Alert).

AU Optronics resolves a split among federal circuits on this jurisdictional issue. In contrast to the Fifth Circuit's *AU Optronics* decision, the Fourth, Seventh and Ninth Circuits had held that CAFA did not operate to provide federal jurisdiction to suits brought by a state attorney general. From a strategic standpoint, class plaintiffs and attorneys general typically view state courts as a preferred forum for claims against corporate entities. In this respect, *AU Optronics* may be seen as a significant shift in the jurisdictional landscape of actions initiated by state attorneys general.

Conflict of Interest Alert:

No Attorney-Client Relationship Between Insurer and Policyholder's Defense Counsel, Says Oregon Court

An Oregon federal district ruled that there was no attorney-client relationship between an insurer and its policyholder's counsel despite the insurer's funding of the policyholder's defense of underlying environmental litigation. On this basis, the court rejected the insurer's attempt to disqualify that counsel in subsequent coverage litigation on the basis of a conflict of interest. *Evraz Inc. v. Continental Ins. Co.*, 2013 WL 617839 (D. Or. Nov. 21, 2013).

Evraz, a steel mill operator, was named as a potentially responsible party in connection with environmental contamination at various sites. Evraz retained the law firm of Stoel Rives in connection with the governmental investigations. Thereafter, Evraz tendered defense of the claims to Continental, one of its

liability insurers. Continental agreed to "share in the reimbursement of reasonable defense costs" pursuant to a reservation of rights. At a later date, Continental stopped funding the defense, and Evraz brought suit. In the coverage litigation, Evraz sought to substitute its original coverage counsel with Stoel Rives. Continental objected, arguing that Stoel Rives's representation of Evraz against Continental would create a conflict of interest because an attorney-client relationship existed between Continental and Stoel Rives in the underlying environmental litigation. The court disagreed.

The court declined to apply a "default rule" under which an attorney-client relationship automatically arises between an insurer and policyholder's counsel. Instead, the court held that an attorney-client relationship may be implied when (1) the putative client subjectively believes that an attorney-client relationship exists, and (2) based on the evidence, that belief is objectively reasonable. Applying this standard, the court concluded that there was no attorney-client relationship between Continental and Stoel Rives based on the following facts:

- Stoel Rives explicitly stated to Continental that it was retained by and acting on behalf of Evraz.
- Stoel Rives had been representing Evraz for several years prior to the coverage litigation, without any involvement by or connection to Continental.
- Evraz paid Stoel Rives directly. Continental "funded" the defense by paying Evraz.
- Continental never expressed any belief or took any action indicating that Stoel Rives represented it.
- Virtually all correspondence from Stoel Rives went directly to Evraz, rather than Continental, including invoices and case status reports.
- Continental did not "insist[ ] on compliance with traditional insurance-defense relationship hallmarks such as creating litigation budgets, providing direct, regular status updates, setting [maximum] amounts for hourly rates, or requiring authorization from Continental before engaging in various litigation tasks."
- Continental served Stoel Rives with a subpoena to obtain documents; "had Continental believed Stoel Rives to be its lawyers, Continental instead would have asserted its right as a client to receive upon request copies of the documents."

Although a tripartite attorney-client relationship is created in many duty-to-defend coverage scenarios, *Evraz* illustrates that under Oregon law, the inquiry is a fact-driven one. Default rules relating to the status of an insurer's relationship with policyholder's defense counsel may be overcome by a specific course of conduct.

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