SIMPSON THACHER
INSURANCE LAW ALERT
JANUARY 2010

Best wishes for the new year. As we turn the pages of our calendars, the new, rapidly-evolving economic environment will likely bring change and present new challenges to the insurance industry. We hope you will continue to turn to Simpson Thacher's Insurance Alert for reports on those developments and to our Firm to help you meet the challenges of the new decade.

–Your Friends at Simpson Thacher

Coverage Alerts:

Legal Standard Proffered by Insurer Governs Consent-To-Settlement Rights, Says Pennsylvania Court of Common Pleas

On December 1, 2009, Judge Stanton Wettick, Jr. of the Pennsylvania Court of Common Pleas addressed a Pennsylvania law matter of first impression: whether and to what extent an insurer's consent-to-settlement rights are enforceable where the insured settles an underlying claim, over a defending insurer's objection, for an amount less than applicable policy limits. *Babcock & Wilcox Co. v. American Nuclear Insurers*, Nos. GD99-011498, GD99-016227 (Pa. Ct. Comm. Pleas Dec. 1, 2009). Adopting the legal standard urged by the defending insurer, American Nuclear Insurers ("ANI"), and its counsel, Andrew S. Amer of Simpson Thacher, the court ruled that an insurer is not required to fund an unauthorized settlement unless the insured can establish by clear and convincing evidence that the insurer's decision to reject the settlement was made in bad faith. In so ruling, the court explicitly rejected the insured's contention that the insurer was obligated to fund the settlement unless it could establish that the settlement was unreasonable. Courts in a number of jurisdictions have applied a reasonableness standard in deciding whether to enforce consent-to-settlement provisions in the context where the insurer has denied coverage or refused to defend, while other courts have focused on factors such as prejudice to the insurer in the context of uninsured/underinsured motorist coverage. In light of the *Babcock* ruling, Pennsylvania law appears to enforce the consent-to-settlement rights of a defending insurer without requiring proof of prejudice to the insurer (which is presumed) and/or reasonableness of the settlement.

In the underlying litigation, several hundred claimants sought damages arising from exposure to nuclear radiation against Babcock & Wilcox ("Babcock") and Altantic Richfield Corporation ("ARCO"). Babcock and ARCO ultimately settled the claims for less than the applicable policy limits. ANI objected to the decision to settle, based on its determination that the underlying cases could be successfully defended. Babcock and ARCO sought coverage for the settlement and ANI declined, asserting that pursuant to the consent-to-settlement clauses in the applicable polices, it had no obligation to indemnify. The specific issue before the court was the appropriate legal standard to be applied in enforcing the consent-to-settlement clauses.

Babcock and ARCO advocated a standard that would require coverage of an unauthorized settlement, so long as the settlement was reasonable and made in good faith. The court rejected this approach, holding under Pennsylvania law that consent-to-settlement

This edition of the Insurance Law Alert was prepared by Mary Beth Forshaw (mforshaw@stblaw.com/212-455-2846) and Bryce L. Friedman (bfriedman@stblaw.com/212-455-2235).

clauses are enforceable absent bad faith, as set forth in *Cowden v. Aetna Casualty and Surety Co.*, 134 A.2d 223 (Pa. 1957). In *Cowden*, the court held: "bad faith, and bad faith alone" is required to render an insurer liable for an unauthorized settlement, and that "bad faith must be proven by clear and convincing evidence." 134 A.2d at 229. Enforcement of a consent-to-settlement clause is justified absent insurer bad faith, the court observed, because it "permit[s] the entity whose money is at stake to negotiate with the other side and to try those cases that may result in a defense verdict or a verdict less than the final demand." Slip op. at 16. This ruling provides substantial support under Pennsylvania law for defending insurers to refuse to indemnify settlements made without insurer approval, even when the potential settlement falls below policy limits.

Costs and Remedies Associated With Clean Air Act Are Not Covered "Occurrences" Under Excess Policies, Indiana Appellate Court Holds

An Indiana appellate court recently affirmed that compliance with court-ordered remedies imposed to prevent future harmful emissions does not constitute an indemnifiable "occurrence" under excess commercial general liability policies. *Cinergy Corp. v. St. Paul Surplus Lines Ins. Co.*, 915 N.E.2d 524 (Ind. Ct. App. 2009). In the underlying suit, Cinergy is alleged to have violated certain provisions of the Clean Air Act ("CAA") by failing to obtain necessary permits and by operating plants without installation of air emission containment equipment. Underlying plaintiffs sought to compel Cinergy to install equipment to reduce future emissions of pollutants. The question before the court presiding over the coverage case was whether the relief demanded in the underlying litigation is covered under the insurers' policies.

Relying in large part on the Indiana Supreme Court's ruling in *Cinergy Corp v. Associated Electric & Gas Ins. Svs., Ltd.*, 865 N.E.2d 571 (Ind. 2007) ("*Cinergy I*"), the appellate court affirmed that the "policies do not provide coverage for the costs of installing equipment to reduce future emissions of pollutants." 915 N.E.2d at 533. The court rejected Cinergy's "resourceful" contention that coverage is due because the underlying plaintiffs also seek "retrospective remedial measures aimed at remediating environmental harm already caused by unlawful air emissions." *Id*. at 533-34.

Addressing whether penalties and attorney fees are covered under the policies, the court ruled in favor of the excess insurers, finding because "[t]here was no occurrence under the terms of the Insurers' policies … any attorney fees or civil penalties imposed in the underlying federal litigation are not covered under the Insurers' policies." *Id*. at 534.

Given the renewed focus on environmental protection and conservation, and the ongoing efforts by businesses to comply with state and federal regulations such as the CAA, companies may turn to their insurers for reimbursement of compliance costs. Numerous state supreme courts have analyzed whether general commercial liability policies provide coverage for environmental response costs, with conflicting results. As evidenced by the Indiana Supreme Court's decision in *Cinergy I*, and as reinforced by the Indiana appellate court in *Cinergy Corp. v. St. Paul Surplus Lines Ins. Co.*, some courts may be unreceptive to arguments that the costs of such compliance efforts constitute covered occurrences under applicable insurance policies. However, as the case law in this area continues to evolve, it appears that a growing number of courts will look to the specific policy language at issue when determining whether governmental response costs constitute damages within the meaning of a general liability policy.

Reinsurance Alert:

Third Circuit Revives Class Action Against Reinsurer and Mortgage Company

A unanimous Third Circuit panel overturned a dismissal of claims brought pursuant to the Real Estate Settlement Procedures Act ("RESPA") against Balboa Reinsurance Co. ("Balboa") and Countrywide Financial Corporation ("Countrywide"). *Alston v. Countrywide Financial Corp.*, 585 F.3d 753 (3d Cir. 2009). Plaintiff home buyers brought the action under RESPA, alleging a kickback scheme between Countrywide and Balboa. According to plaintiffs, their private mortgage insurance premiums were channeled into an unlawful "captive reinsurance arrangement" in which Countrywide referred homeowners to specific mortgage insurers that would then reinsure their mortgage policies with Balboa, a Countrywide affiliate. Plaintiffs allege that Balboa did not assume risk commensurate with the amount of premiums received from the primary mortgage insurers. According to the complaint, Balboa has collected more than $892 million in reinsurance premiums since 1999 and has yet to pay any claims. 585 F.3d at 757. Plaintiffs contend that the reinsurance premiums paid to Balboa were, in fact, kickbacks to Countrywide by the primary insurers, paid in exchange for Countrywide's referral of the private mortgage insurance business. The district court dismissed the action, finding that because the homeowners had not paid more than the legal rate for mortgage insurance, they failed to establish actual or threatened injury, and thus had no standing under RESPA.

On appeal, the Third Circuit framed the central legal issue as follows: Is there a "private right of action for a consumer who alleges a violation of RESPA … even if that violation does not result in a traditional, monetary injury in the form of an overcharge for settlement services"? 585 F.3d at 758. Despite a split of district court authority across numerous jurisdictions, 585 F.3d at 760 n.7, the Third Circuit answered this question in the affirmative, concluding that the language in RESPA unambiguously provides for damages based on the settlement service amount, with no requirement that there has been an overcharge.

Based on this holding, RESPA may prove to be a vehicle for the filing of private actions against insurers or reinsurers in connection with allegedly improper mortgage schemes. RESPA provides for treble damages over the total charge paid by the consumer. Whether such claims will ultimately succeed, however, remains to be seen. The *Alston* decision speaks only to the issue of standing under RESPA, and not to the merits of claims against insurance or reinsurance entities. Moreover, whether RESPA claims such as those asserted in *Alston* can meet the standards necessary to proceed as a class action may prove to be an obstacle. Although the Third Circuit did not address the issue in *Alston*, the Fifth Circuit recently reversed a district court's order certifying a class as to a RESPA claim. In *Mims v. Stewart Title Guaranty Co.*, No. 09-10127, 2009 WL 4642631 (5th Cir. Dec. 9, 2009), the Fifth Circuit found that under the theory of liability advanced by the plaintiffs and accepted by the district court on a previous motion to dismiss, class certification was improper because RESPA claims should be addressed on an individual, transaction-by-transaction basis.

Legislation Alerts:

New York State Legislature Abrogates Insurer's Subrogation Rights Against Settling Parties

On November 12, 2009, New York State Governor David A. Patterson signed new legislation which

abrogates the right of certain insurers to subrogate against a settling party in a personal injury or wrongful death action. General Obligations Law §5-335, which applies to any insurer or entity qualifying as a "benefit provider," removes all liens and rights to subrogation or reimbursement against any party to settlement in a personal injury or wrongful death civil suit. The new law prohibits subrogation in such circumstances by creating a conclusive presumption that settlements in personal injury or wrongful death suits do not include compensation for loss that is covered by insurance. The legislation sets forth two exceptions to this rule: (1) the provision does not apply to subrogation claims seeking recovery of additional first party benefits that may be provided under New York's no-fault statute; and (2) the provision does not eliminate a right to subrogate which derives from a statute, such as Workers' Compensation or Medicaid recovery rights. In essence, the law eliminates subrogation rights that emanate from either contract or common law. The new law applies to all actions filed on or after November 12, 2009, and to all pending actions in which trial has not commenced and/or the parties have not entered into a stipulation of settlement.

Interestingly, this new legislation comes on the heels of the New York Court of Appeals decision in *Fasso v. Doerr*, 12 N.Y.3d 80 (2009). In *Fasso*, the court had ruled that an insurer's equitable subrogation claim against a tortfeasor is not extinguished by a settlement between the insured and the tortfeasor.

Notably, the new legislation does not affect subrogation rights for property damage claims, and thus should not apply to first party property insurers. Additionally, because the statute applies only to subrogation claims against settling parties, benefit providers may still pursue claims against tortfeasors and/or join pending actions prior to settlement.

National Conference of Insurance Legislators Adopts Model Legislation To Regulate Credit Default Swaps

On November 22, 2009, the National Conference of Insurance Legislators ("NCOIL") adopted model legislation to prohibit "naked" credit default swaps and to oversee "covered swaps" under state insurance regulation.

Pursuant to a credit default swap ("CDS"), a protection buyer contractually agrees to make a payment or series of payments to a protection seller. In exchange, the protection buyer receives a payout from the protection seller if a specified credit event occurs with respect to the obligations referenced in the CDS contract. Generally, the amount received by the protection buyer is measured by the decrease in market value of the referenced obligation upon the occurrence of the credit event, regardless of whether the holder of that obligation suffered an actual loss. Although parties to a CDS may agree upon any specific credit event, frequently listed credit events are bankruptcy, the failure to make a payment or the restructuring of the debt obligation. A CDS is considered "naked" when the protection buyer neither owns nor has an economic interest in the underlying instrument. In contrast, a CDS is "covered" when the protection buyer owns or has an economic interest in the underlying instrument. CDSs, which have come under increasing public scrutiny, are often used to control variations in a portfolio's market value by providing contractual protection against defaults and value decreases. For example, an investor may hedge his exposure on a bond instrument by entering into a CDS for that bond, such that if the bond goes into default, the CDS payoff will offset the reduced market value of the bond.

The CDS market has reached multi-trillion dollar

values, and according to some, has played a significant role in the collapse of the financial industry. Historically, a CDS has not been considered a form of insurance, and has remained virtually unregulated on both state and federal levels. NCOIL's model legislation seeks to define all forms of CDS as credit default insurance ("CDI"). Further, the model legislation specifies that CDI may be issued only to a party that has, or is expected to have at the time of the credit event, a material interest in the specified obligation. All other CDI (i.e., "naked" CDI) is considered unlawful and subject to penalties. Additionally, the model provides a state regulatory scheme to govern the CDI market by establishing strict licensing and financial requirements for entities seeking to operate as CDI companies, such as capital adequacy requirements, and the maintenance of contingency, loss and unearned premium reserves similar to those necessary under New York's Financial Guaranty Insurance Law (Article 69).

According to the NCOIL, the model "fill[s] a regulatory void created by a decade of federal deregulation." It remains to be seen, however, whether federal legislators or regulators will pursue their own forms of CDS regulation via financial reform initiatives. Federal congressional proposals may conflict with or overlap NCOIL's model legislation.

Global Warming Alert:

EPA Finding Adds To Momentum For Global Warming Nuisance Suits

In December 2009, the Environmental Protection Agency ("EPA") issued a widely-anticipated finding that greenhouse gases threaten public health. This finding will likely fuel the new wave of climate change litigation, and may serve to bolster existing public nuisance suits against greenhouse gas emitters, such as those recently reinstated by both the Second and Fifth Circuit Courts of Appeals. *See Conn. v. Am. Elec. Power Co.*, 582 F.3d 209 (2nd Cir. 2009); *Conner v. Murphy Oil USA*, 585 F.3d 855 (5th Cir. 2009).

Equally important, the EPA finding provides valuable ammunition for insurers in future coverage disputes, which will likely follow recently-filed global warming related tort claims. The EPA's conclusion that greenhouse gases threaten public welfare, together with the United States Supreme Court's 2007 ruling that greenhouse gases fall within the definition of "pollutants" under the Clean Air Act (*Massachusetts v. Environmental Protection Agency*, 127 S. Ct. 1438 (2007)), supports the notion that carbon dioxide and other greenhouse gases that allegedly contribute to global warming constitute pollutants that fall squarely within a standard commercial liability pollution exclusion.

Privilege Alert:

Implications of Textron*: Stricter Scrutiny for Privilege Protection?*

In the recently-decided matter of *United States v. Textron Inc.*, 577 F.3d 21 (1st Cir. 2009), the First Circuit appeared to endorse a more stringent standard for applying the work product doctrine. In *Textron*, a divided en banc panel held that the work product doctrine does not shield a company's tax accrual work papers, which are based in part on counsel's assessment of litigation risk. The First Circuit stated: "It is not enough to trigger work product protection that the *subject matter* of a document relates to a subject that might conceivably be litigated … Nor is it enough that the materials were prepared by lawyers or represent legal thinking." 577 F.3d at 29-30.

Citing to the *Textron* decision, a federal Pennsylvania district judge recently held that certain articles authored by Life Investors Insurance Company of America ("Life Investors") were not protected by the work product doctrine. *Smith v. Life Investors Ins. Co. of America*, No. 2:07-cv-681, 2009 WL 3364933 (W.D. Pa. Oct. 16, 2009). Interpreting the phrase "prepared in the course of preparation for possible litigation," the court noted that "bald assertions" lacking any explanation as to why the company anticipated litigation and how the documents at issue were created because of that prospect of litigation were insufficient to cloak the documents at

issue with work product protection. *Id*. at *7.

Ruling on a related privilege issue, the court also granted a motion to compel the deposition of in-house counsel for Life Investors. Class action plaintiffs sought to depose Life Investor's in-house counsel, who had served on a task force created to evaluate whether the company should reduce reimbursement rates to its customers. Life Investors refused to produce in-house counsel on the basis of attorney-client privilege. The court rejected this defense, observing that in-house counsel had engaged in non-privileged business activities in working on the task force, and in the training of claims examiners and customer service personnel. *Id*. at *5. The court stated: "While such depositions are disfavored, the mere fact that Edwards is an attorney is not an absolute bar to the taking of his deposition." *Id*. The court also recognized that Life Investors would be entitled to assert any applicable privilege on a question-by-question basis.

The *Textron* decision represents a departure from previous First Circuit precedent, and appears to create an intercircuit conflict regarding the applicable standard for work product protection. On December 24, 2009, Textron filed a petition for writ of certiorari in the Supreme Court of the United States. However, until the intercircuit conflict is resolved, litigators should be on notice that documents that analyze anticipated litigation, but that are prepared primarily for business purposes, such as the creation of financial statements, may be the subject of discovery requests and motion practice. Likewise, in light of the *Life Investors* ruling, a court may not consider the testimony of in-house counsel to be protected by privilege if counsel has engaged in decidedly non-legal business activities. Privilege-related trial court decisions take on heightened significance in light of the United States Supreme Court's recent decision in *Mohawk Indus., Inc. v. Carpenter*, 130 S. Ct. 599 (2009), which holds that disclosure orders adverse to the attorney-client privilege do not qualify for immediate appeal under the collateral order doctrine.

Publication Announcement:

Simpson Thacher is proud to announce the December 21, 2009 publication of the 15th edition of the *Handbook on Insurance Coverage Disputes*, co-authored by Barry R. Ostrager. The *Handbook* discusses thousands of insurance-related decisions issued over the past two decades, including the most recent and significant rulings that have altered the landscape of insurance law. The *Handbook* continues to be one of the most comprehensive and cited reference works on insurance law.

Simpson Thacher has been an international leader in the practice of insurance and reinsurance law for a quarter of a century. Our insurance litigation team practices worldwide.

Barry R. Ostrager
(212) 455-2655
bostrager@stblaw.com

Mary Kay Vyskocil
(212) 455-3093
mvyskocil@stblaw.com

Andrew S. Amer
(212) 455-2953
aamer@stblaw.com

David J. Woll
(212) 455-3136
dwoll@stblaw.com

Mary Beth Forshaw
(212) 455-2846
mforshaw@stblaw.com

Andrew T. Frankel
(212) 455-3073
afrankel@stblaw.com

Lynn K. Neuner
(212) 455-2696
lneuner@stblaw.com

Seth A. Ribner
(310) 407-7510
sribner@stblaw.com

Chet A. Kronenberg
(310) 407-7557
ckronenberg@stblaw.com

Linda H. Martin
(212) 455-7722
lmartin@stblaw.com

Bryce L. Friedman
(212) 455-2235
bfriedman@stblaw.com

Michael D. Kibler
(310) 407-7515
mkibler@stblaw.com

Michael J. Garvey
(212) 455-7358
mgarvey@stblaw.com

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

George S. Wang
(212) 455-2228
gwang@stblaw.com

Elisa Alcabes
(212) 455-3133
ealcabes@stblaw.com

[Simpson Thacher] consistently headlines the country's biggest [insurance] cases, displaying wide-ranging expertise and a strong bench.

—Chambers USA 2009

The contents of this publication are for informational purposes only. Neither this publication nor the lawyers who authored it are rendering legal or other professional advice or opinions on specific facts or matters, nor does the distribution of this publication to any person constitute the establishment of an attorney-client relationship. Simpson Thacher & Bartlett LLP assumes no liability in connection with the use of this publication. The information contained in this memorandum does not represent, and should not be regarded as, the view of any particular client of Simpson Thacher.

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2550 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

EUROPE

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

ASIA

Beijing
3119 China World Office One
1 Jianguomenwai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower - 35th Floor
3 Garden Road, Central
Hong Kong
+852-2514-7600

Tokyo
Gaikokuho Jimu Bengoshi Jimusho
Ark Mori Building
12-32, Akasaka 1-Chome
Minato-Ku, Tokyo 107-6037
Japan
+81-3-5562-6200

LATIN AMERICA

São Paulo
Av. Presidente Juscelino Kubitschek, 1455
12th Floor, Suite 121
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000