Risk Radar

Hot Topics to Watch in the Coming Months

By Michael J. Stoner

California

***Reid v. First Mercury Company* (2013) WL 5517979**

In 2012 the 9th Circuit issued an opinion that held that an insurance company commits bad faith if it fails to *initiate* settlement discussions, or offer policy limits, once the insured's liability in excess of policy limits became reasonably clear. *Du v. Allstate Ins. Co.,* 681 F.3d 1118 (9th Cir. 2012), *amended by, Du.v. Allstate Ins. Co.*, 697 F.3d 753 (9th Cir. 2012). The 9th Circuit backtracked from this opinion when it amended its decision in *Du*. The amended decision removed any discussion regarding an insurance company's duty to *initiate* settlement discussions, largely because the facts in *Du* did not implicate the issue. The amended decision explained that the insurance company in *Du* did, in fact, broach settlement with the claimant at a reasonable point in the case.

But the amendment to the *Du* opinion did not affirmatively overrule its statements regarding an insurance company's bad faith for failure to initiate settlement discussion. As such, the issue was murky at best following *Du*. Last October the California Court of Appeal explicitly addressed the issue of whether an insurance company is liable for bad faith by failing to initiate settlement discussions in the absence of a demand or settlement offer by the claimant. The *Reid* case held that the implied covenant of good faith and fair dealing does *not* require the insurance company to initiate settlement discussions. The court explained that "[a]n insurance company's duty to settle is not precipitated solely by the likelihood of an excess judgment against the insured. In the absence of a settlement demand or other manifestation the injured party is interested in settlement, when the insurance company has done nothing to foreclose the possibility of settlement, we find there is no bad faith failure to settle."

Policyholders should be alert to ensure that insurance companies do not interpret *Reid* too broadly. *Reid* does not require a formal settlement demand by the plaintiff for bad faith liability to attach. Rather, there need only be "some evidence either that the injured party has communicated to the insurance company an interest in settlement, or some other circumstance demonstrating the insurance company knew that settlement within policy limits could feasibly be negotiated." But without any indicia of an interest in settling, the insurance company cannot be taxed with the excess judgment rule.

Following *Reid*, plaintiff attorneys seeking to trigger the excess judgment rule must affirmatively communicate some interest in settlement to the insurance company. Furthermore, under *Reid*, a "bare request to know the policy limit" does not create an "opportunity to settle" or constitute "an initiation of settlement." Plaintiff attorneys seeking to blow the top off an insurance policy should keep in mind that documenting a likely liability in excess of policy limits will be insufficient to trigger the excess judgment rule — the plaintiff must also communicate settlement interest to the plaintiff.

Oregon

Anderson Brothers, Inc. v. St. Paul Fire and Marine Insurance Company, No. 12-35346, -35454, (9th Cir., 08/30/2013)

Most companies are aware that comprehensive general liability policies purchased during the 1970s can often be utilized to defend and indemnify against third party pollution claims. But fewer may realize that many of these policies can be used to defray the costs of responding to Environmental Protection Agency inquiries, even absent a formal complaint.

Under a typical comprehensive general liability policy sold during the 1970s, the insurance company agrees that it "will pay on behalf of the insured all sums which the insured shall become legally obligated to pay as damages because of: . . . property damage to which this insurance applies, caused by an occurrence, and the company shall have the right and duty to defend any *suit* against the Insured seeking damages on account of such property damage." (Emphasis added). Insurance companies often take the position that its obligation to defend a "suit" is triggered only by a traditional lawsuit or arbitration. And some courts have accepted that premise.

However, other courts have recognized that the insurance company's promise to pay defense costs to its policyholder goes well beyond this scope. And in *Anderson Brothers*, the 9th Circuit confirmed on Aug. 13, 2013, that under Oregon law, insurance companies cannot deny the defense costs paid by the policyholder in responding to certain letters issued by the EPA. Specifically, *Anderson Brothers* held that the following communications from the EPA constituted a "suit" under Oregon law, thereby triggering a duty to pay defense costs under the insurance policy:

- A General Notice Letter under Sections 106 and 107 of the Comprehensive Environmental Response, Compensation, and Liability Act identifying the policyholder as a potentially responsible party.

- An Information Request Letter under Section 104(e) of CERCLA seeking information regarding activities that may have resulted in releases of hazardous substances.

The *Anderson Brothers* court explained that the General Notice Letter under Sections 106 and 107 of CERCLA constituted a "suit" in the overwhelming majority of jurisdictions. Given the broad powers vested in the EPA to compel remediation, and the vital necessity of a potentially responsible party in participating settlement negotiations with the EPA as early as possible, *Anderson Brothers* and other courts have described the policyholder's receipt of a general notice letter as "the functional equivalent of a 'suit.'"

The *Anderson Brothers* reached a similar result with respect to the information request letter. The 9th Circuit explained that the term "suit" — undefined in the policy — was susceptible to two different interpretations. The broader interpretation, and the one advocated by the policyholder, was "to attempt to gain an end by any legal process." This interpretation was consistent with the Oregon Environmental Cleanup Assistance Act's definition of "suit," which includes "any action or agreement by the . . . [EPA] against or with an insured in which . . . the [EPA] in writing directs, requests, or agrees that an insured take action

> *"Few companies may realize that comprehensive general liability policies can be used to defray the costs of responding to an Environmental Protection Agency inquiry."*

with respect to contamination within the State of Oregon." Considering that the Section 104(e) letter requested that the policyholder respond to an 82-question information request, and that compliance with the information request was required by law, the court found that this communication also constituted a "suit" under the policy.

Based on cases such as *Anderson Brothers* and others, policyholders facing information requests by the EPA should demand that their insurance companies honor their defense obligation by defending these suits. Considering that the costs of responding to EPA letters and information requests can be significant, policyholders would be remiss in failing to notify their insurance companies of such a development.

CONTINUED NEXT PAGE

New York

***Zurich American Insurance Co. v. Sony Corporation of America, et. al.*, Case Number 651982-2011**

Does a comprehensive general liability policy cover claims arising out of third party hacking events? According to a New York case decided in February 2014, the answer was no. The *Sony* case is one of the first to address this issue. The *Sony* case arose out of the highly publicized data breach of Sony's Playstation Network in April 2011. The hacking incident resulted in the theft of personal details from approximately 77 million accounts and forced Sony to shut off its Playstation Network for approximately 24 days. It still remains as one of the largest data security breaches in history.

> *"A company relying on a comprehensive general liability policy to cover cyber liabilities does so at its own risk. Policyholders can expect the insurance industry to seize upon the Sony ruling to limit the scope of insurance."*

As a result of the Playstation Network hack, approximately 50 to 60 class action lawsuits were brought against Sony by its customers. Zurich American, one of the insurance companies that sold Sony a comprehensive general liability policy, also sued Sony for declaratory relief that it owed no duties to Sony with respect to these lawsuits under the policy it sold.

The central issue in the coverage case was whether the lawsuits alleged "oral or written publication in any manner of material that violates a person's right of privacy," as found under the "personal and advertising injury" section of a standard comprehensive general liability policy. Zurich American argued that the policy only insured claims or lawsuits where the policyholder — in this case Sony — was responsible for the publication. Sony responded that there was no language in the insuring agreement that states that the liability must arise out of the policyholder's publication.

In a bench opinion, Judge Jeffrey K. Oing adopted Zurich American's argument. Judge Oing explained, "The hackers did this, they took it. That's not the same as saying Sony did it . . . [T]he policy requires the policyholder to commit the acts, it does not extend to third parties." In other words, because the publication was committed by the hackers, and not Sony, the lawsuits fell outside the scope of insurance.

Whether Judge Oing's reasoning will be affirmed on appeal, or adopted by other jurisdictions, remains to be seen. After all, the policy covers "oral or written publication in any manner of material" so there is no specific requirement that the publication be made by the policyholder. Sony's argument that the insurance company could have explicitly limited the scope of the coverage agreement to oral or written publication *by a policyholder* in any manner may be persuasive to other courts less hostile to policyholder rights than New York. Accordingly, this case (and others like it) merit continued attention going forward.

But the larger point to take away from *Sony* is that a company relying on a comprehensive general liability policy to cover cyber liabilities does so at its own risk. Policyholders can expect the insurance industry to seize upon the *Sony* ruling to limit the scope of insurance, if any, under a comprehensive general liability policy for acts committed by hackers. If *Sony* is upheld on appeal, there may be an uptick in demand for cyber-liability policies that specifically cover this type of loss.

Texas

***Ewing Construction v. Amerisure Insurance Co., No. 12-0661, 2014 WL 185035 (Tex. Jan. 17, 2014) and Lennar Corporation v. Markel American Insurance Company*, No. 11-0394 (Tex. August 23, 2013)**

The January 2014 Texas Supreme Court ruling in *Ewing Construction* is the latest in a series of Texas Supreme Court decisions relating to the availability of insurance for a general contractor facing a claim for defective construction. A victory for policyholders, the *Ewing Construction* case limits the ability of insurance companies to assert the contractual liability exclusion as a basis for denying insurance. Unless the contract enlarges the scope of the policyholder's liability beyond general negligence law, the contractual liability exclusion should not be invoked.

Under Texas law, the insuring agreement of a comprehensive general liability policy includes insurance for claims asserting property damage caused by an insured's defective performance or faulty workmanship when the property damage results from the unexpected or unforeseen happening or consequence of the policyholder's negligent behavior. *Lamar Homes v. Mid-Continent Casualty Co.*, 242 S.W.3d 1, 16 (2007). Should insurance companies wish to narrow the scope of coverage they can "restrict and shape the coverage otherwise afforded" through the use of policy exclusions. *Id.* at 10. One of the policy exclusions relied on by insurance companies in the claims of faulty workmanship is the contractual liability exclusion that precludes insurance for:

> "Bodily injury" or "property damage" for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement. This exclusion does not apply to liability for damages: (1) Assumed in a contract or agreement that is an "insured contract," or (2) The insured would have in the absence of the contract or agreement.

The scope of the contractual liability exclusion took center stage in the *Ewing Construction* decision. At issue was whether the exclusion precluded insurance for a lawsuit alleging that tennis courts constructed by a general contractor were flaking, crumbling and cracking, rendering them unsuitable for the intended purpose of hosting competitive tennis events. The underlying claimant sought damages against the policyholder on two theories: breach of contract and negligence.

To arrive at its decision, the Texas Supreme Court relied in large part on its 2010 decision in *Gilbert Texas Construction, L.P. v. Underwriters at Lloyd's London*, 327 S.W.3d 118 (Tex. 2010). The Texas Supreme Court explained that *Gilbert* interpreted the term "assumption of liability" in a comprehensive general liability policy to require "that the insured has assumed a liability for damages that exceeds the liability it would have under general law." The Ewing Construction court then explained that "a general contractor who agrees to perform its construction work in a good and workmanlike manner, without more, does not enlarge its duty to exercise ordinary care in fulfilling its contract." Therefore, the *Ewing Construction* court concluded that the contractual liability exclusion did not apply, because there was no "assumption of liability in a

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contract or agreement." Instead, the policyholder's promise to perform its work in a good and workmanlike manner simply tracked its general obligation to exercise reasonable care under the doctrine of negligence. In other words, if the scope of liability under the contract is coterminous (or less than) the scope of liability under a negligence theory, the contractual liability exclusion should not apply, as there has been no "assumption of liability."

In *Lennar*, Texas policyholders scored a major victory last August when the Texas Supreme Court confirmed that Texas follows the "all sums" rule for long-tail property damage claims.

The *Lennar* case involved damages to several homes occurring over several years caused by the use of an exterior insulation and finish system rather than conventional stucco. It was undisputed that damage to the homes occurred before, during and after the policy period. The policyholder in *Lennar* sought the full amount of the loss up to the policy limits in accordance with the policy's obligation to pay the total amount of the loss (all sums). The insurance company sought to pay only the damage that occurred during the policy period, or, alternatively, a "pro rata" amount of the loss based on its proportionate time on the risk.

The all sums rule comes into play in situations like *Lennar*: When a policyholder may be liable for continuing damage occurring over several successive policy periods. If a triggered insurance policy promises to pay all sums for which the insured is liable, then that insurance company must cover the entire amount of the policyholder's loss (up to the policy limits) even if the damage occurred prior to, or after, that policy period. On the other hand, insurance companies often urge courts to apply the pro rata approach, which would permit an insurance company to a pro rata reduction based on the insurance company's respective time on the risk or liability limit. Despite the fact that this approach contradicts the all sums language in the insurance policy, some states have been persuaded by the insurance industry in adopting the pro rata approach.

By confirming the applicability of the all sums rule, *Lennar* represents a significant victory for policyholders. Insurance policies subject to Texas law rightly obligate the insurance company to pay the full extent of the insured's liability, "leaving up to insurance companies who share responsibility for a loss to allocate it among themselves according to their subrogation rights." The all sums rule provided for in *Lennar* allows the policyholder to "get its money and get out," leaving the insurance companies to deal with the expensive and time-consuming process of allocating the total amount amongst themselves. ▲

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