

FALL 2019

INSURANCE UPDATE

CONTACT US

TIMOTHY DIEMAND
tdiemand@wiggin.com

JOSEPH GRASSO
jgrasso@wiggin.com

MICHAEL MENAPACE
mmenapace@wiggin.com

ROBYN GALLAGHER
rgallagher@wiggin.com

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Property Insurance, Cyber Insurance, Coverage and War: Losses From Malware May Not Be Covered Due To Your Policy's Hostile Acts Exclusion

by Michael Menapace

Is malware war? Are losses arising from malware excluded from your property insurance policy?

These are questions businesses should consider. There are, of course, policies specifically written to cover cyber breaches and other data security incidents. But, these types of policies are, indeed, different from property policies. Even if both types of policies contain similarly named/titled terms, conditions, and exclusions, they intend to cover different risks and their language can be different.

Some recent cyber incidents have given rise to an examination of cyber losses under property coverage and provide a reminder that a good risk management program keeps the differences between property and cyber coverage in mind. Business leaders must consider the specific language of their insurance policies before assuming what is covered and what is excluded because, in the end, the specific language of each insurance contract will control any dispute over a claim.

The Evolution of Property Policies

Today's common property insurance policies developed from insurance originally designed to protect property owners from the risk of fire. That is, they were designed to cover damages to an insured's physical property against a specific type of loss. Imagine a fire sweeping through a 19th century warehouse. While the scope of risks covered by most property insurance policies has expanded and the language of the policies' terms has evolved, the fact remains that the purpose of property insurance is to pay for first party losses due to the physical damage or loss of tangible property—for example, a company that experiences a loss of a building and other property, such as machinery, due to a fire, tornado, or a truck crashing through the front door should look to its property insurance for coverage. Another evolution of property policies is that they typically now cover the cost of business interruption due to the necessary suspension of business activities tied to direct physical loss of or damage to covered physical property.

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CASE SUMMARIES

Standards for Bad Faith Awards to Be Reviewed by Pennsylvania Supreme Court

Berg v. Nationwide Ins. Co.

This case is making its second trip to the Pennsylvania Supreme Court, which agreed to hear the current appeal in March 2019. Briefing is underway, with the Court expected to rule later this year or early next.

The facts of the case are relatively simple, but it suffers from an unfortunately long and convoluted procedural posture. After a 1996 auto accident, plaintiffs claimed damage to their auto. When the litigation was commenced in 1998, the insureds argued that their insurer had wrongly refused to pay for a total loss of the vehicle, instead paying only for repairs which rendered the vehicle unsafe. The first trial in the case occurred in 2004, with the jury finding in favor of the insurer on almost all claims, with the exception of an unidentified violation of a Pennsylvania unfair or deceptive acts and practices statute. The insureds were awarded just over \$2,000. Three years later, the trial court took up the bad faith claim, finding in favor of the insurer. That judgment was appealed and affirmed by an appellate court. It was then reversed and remanded by the Pennsylvania Supreme Court in 2010. On remand, the appellate court found that the trial court had erred and further remanded the case back to the trial court in 2012.

In round two, the trial court (with a new judge assigned to the case) found in favor of the insureds, awarding them \$18 million in punitive damages and \$3 million in attorneys' fees in 2015. That judgment was also appealed. The appellate court overturned the award, finding insufficient evidence in the record to support bad faith, essentially substituting its judgment on the issue for the trial court's (and noting in the process that the trial judge may have been biased against the insurer). This is the case currently pending before the Pennsylvania Supreme Court where that Court will need to decide to what extent and under what circumstances can an appellate court may overturn findings of bad faith by trial courts.

While bad faith claims are typically fact dependent (and in this case, the passage of over 20 years and the expenditure of millions of dollars in legal fees did not help), the ultimate resolution in the case may have a strong impact on future insurance coverage litigation in Pennsylvania. We will therefore follow the case with interest.

Insurers Cannot Force Arbitration When Policy Is Governed by International Convention on Foreign Arbitration

McCullough v. Royal Caribbean Cruises

The US District Court for the Southern District of Florida held that an insurer could not force arbitration of a coverage dispute raised in the context of a direct claim for bad faith by an injured third-party claimant, where the arbitration provision in the insurance policy is governed by the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the "Convention"). The case involved a tragic zip-line accident during a day-trip on a Royal Caribbean cruise, leaving the claimant quadriplegic. The claimant brought a bad faith claim against Royal Caribbean's insurer, AIG, for failure to settle in good faith on behalf of its insured, despite the fact that AIG had consistently contested coverage. As an initial matter, the court held that the bad faith claim was premature absent a finding of coverage.

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McCullough v. Royal Caribbean Cruises CONTINUED

But AIG also argued that the third-party claimant had to arbitrate the question of coverage based on the dispute resolution provision in Royal Caribbean's policy. The claimant argued that they were non-signatories to the insurance policy and, therefore, could not be forced into arbitration. AIG's argument was premised on the idea that in a third-party bad faith action, the claimant steps into the shoes of the insured who is necessarily a signatory to the agreement to arbitrate. The claimant responded that they are neither signatories to the insurance policy nor assignees of the insured's rights and therefore they have not assumed the obligation to arbitrate. The court agreed with that argument. "A party cannot be required to submit to arbitration any dispute which he has not agreed so to submit." The court also distinguished compelling arbitration under the US Federal Arbitration Act, which recognizes that an estoppel theory can be used to bind non-signatories to arbitration, with compelling arbitration under the Convention, which does not. "[B]ecause there is no agreement signed by both parties, the [claimant] cannot be compelled to arbitrate." The court therefore stayed the action until "coverage under the Policy has been established."

A Stipulated Judgment Amount Is Not Necessarily the Measure of Bad Faith Damages

Draggin' Y Cattle Company, Inc. v. Junkermier

The Supreme Court of Montana held that the measure of damages for an insurer's alleged bad faith failure to settle is not presumed to be equal to the amount of a stipulated judgment between the insured and the plaintiff, where the insurer had accepted its obligation to defend. Where an excess judgment appears likely, or even possible, an insured may feel pressured to mitigate its risk by entering into a stipulated judgment above policy limits with the plaintiff with the additional condition that the plaintiff cannot seek to recover from the insured directly. In those circumstances, the insured will assign its rights under the insurance policy to the plaintiff. In this way, the insured is shielded from the possibility of being exposed to damages exceeding policy limits and the plaintiff is empowered to proceed directly against the insurer. However, this strategy is rife with peril for insurers and insureds alike.

Often these types of back-room deals are prohibited under the terms of the insurance policy because they deprive the insurer, the entity that will end up making payment on the claim, of input into the settlement amount. However, "[w]hen an insurer breaches the duty to defend, it loses the right to invoke insurance contract defenses or to assert policy limits." Absent a defense by the insurer, the insured is justified in taking steps limiting personal liability through a settlement and that settlement will be recognized as presumptively reasonable. These same concerns are not implicated, however, when the insurer has accepted the duty to defend and is providing an active defense. "When the insurer has accepted the defense of the claim, and might have prevailed at trial had the insured and the claimants not settled without the insurer's participation, no presumption of the insured's liability generally arises from the fact or amount of settlement."

In *Draggin' Y Cattle Co.*, the insurer had accepted the duty to defend and therefore, under the general rule discussed above, no presumption of reasonableness would be afforded the claimant's settlement with the insured. The claimant sought to avoid this general rule by arguing that while the insurer had not technically breached the duty to defend, it had breached numerous other provisions of the policy, resulting in a constructive abandonment of the insured. Notably, one of the alleged duties that the plaintiffs claimed had been breached was the failure of the insurer to instigate a declaratory judgment action as to

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Draggin' Y Cattle Company, Inc. v. Junkermier CONTINUED

coverage, given the coverage dispute. The court rejected the invitation to create a new duty, declining "to impose as a matter of law a new obligation on a defending insurer... to file a declaratory judgment action before the resolution of the liability case..." The claimant also argued that based upon the insurer's behavior, the insured needed to settle to protect themselves from a judgment far in excess of policy limits. The court rejected this argument as well, noting that there are other remedies available in the event of an excess policy judgment including through a breach of contract action or an Unfair Trade Practices Action. Thus, there is no need to presume the reasonableness of the settlement. "[T]his Court has never approved a confessed judgment as the proper measure of damages where the insurer defended its insured."

New York Applies "All Sums" Across Successive Policies in Asbestos Cases

In re Liquidation of Midland Ins. Co

A New York appellate court recently applied an "all sums" method, rather than *pro rata*, across successive policies for asbestos exposure losses. The court ruled that under New York law, the all sums approach was "generally required" under the 2016 Viking Pump, Inc. decision, 27 N.Y.3d 224, 260-61. In this case, the court also looked at the language of the specific excess policies at issue, which were follow-form policies that incorporated the non-cumulation clauses of the underlying policies issued by American Home Assurance Company. The court reasoned: The non-cumulation clauses plainly contemplate that multiple successive insurance policies can indemnify the insured for the same loss of occurrence... thereby rendering all sums the appropriate allocation method. Vertical exhaustion, the court stated, is consistent with an all sums allocation and required in this situation.

IN THE NEWS

- Tim Diemand has been recognized for the fourth consecutive year by Chambers USA – in the Commercial Litigation category for 2019 – and has been recognized for the ninth consecutive year by Benchmark Litigation – as a "Litigation Star" for 2020.
- For the sixth consecutive year, Wiggin and Dana received the *Connecticut Law Tribune's* Litigation Department of the Year recognition. The department was honored at an awards dinner on May 26, 2019 at the Bond Ballroom in Hartford, CT.
- Wiggin and Dana partners, Michael Menapace and Kevin Carroll presented a webinar in June titled, "Silent Cyber and War - Gaining Coverage for Cyber Losses Under Non-Cyber Policies and Excluded Losses." Michael and Kevin discussed how cyber exposures can be triggered, what those covered by such insurance policies should expect when making a cyber-related claim on non-cyber policy, and how the "Hostile Acts exclusion" applies. For more information, please contact Michael.
- Joe Grasso will be moderating a panel on "Cyber Crime and Implications for the Marine Insurance Industry: Exposure and Coverage Issues," in Mexico City on October 1st, as part of the 2019 CMI Colloquium. He attended the IUMI conference in Toronto and the IMCC conference in Ireland in September.
- Michael Menapace has authored, "Additional Insureds: Additional Protection and Additional Issues," which appears in the Summer edition of the American Bar Association's *The Brief*, a publication of the American Bar Association Tort Trial and Insurance Practice Section.

