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Insurers Gained Ground In Key 2010 Rulings

By **Samuel Howard**

Law360, New York (January 1, 2011) -- The most important insurance rulings in 2010 came in cases concerning failed banks, reinsurers' settlement obligations, and directors and officers policies, with courts settling law in many gray areas and giving insurers cause for comfort.

The big decisions of 2010 ran the gamut from coverage for defective drywall to the primacy of the so-called follow the fortunes doctrine and the admissibility of arbitrators.

Taken as a whole, however, the year's most significant rulings entrenched the trend of courts handing down rulings that benefit direct insurers, with key decisions firming up coverage exclusions and reinsurance obligations to ceding companies, according to experts in the field.

"These cases, in the main, have gone in the direction in which insurance and reinsurance has been trending. I think that direct insurers would be generally pleased with the direction the law is being clarified," Barry Ostrager of Simpson Thacher & Bartlett LLP said.

The following are the rulings from 2010 that had the greatest impact on insurance law:

Travelers Casualty Co. v. Insurance Co. of North America

In June, the U.S. Court of Appeals for the Third Circuit fortified the follow the fortune doctrine, rebuffing Insurance Co. of North America's challenge to Travelers' allocation of a $137 million settlement and freeing the insurer from having to minimize its reinsurance recovery in its post-settlement allocations.

The appeals court did not embrace the lower court's reasoning but largely reached the same result, reinforcing the follow the fortunes doctrine in post-settlement allocation disputes and ultimately protecting cedents from attacks by reinsurers dissatisfied with their purported liability.

The dispute stemmed from Travelers' $137 million settlement over breast implant and pesticide injury claims, turning on how the ceding company allocated liabilities across 11 years of coverage and three layers of primary and excess insurance.

Travelers sought to recoup $13 million from INA. The district court concluded that Travelers' allocation was reasonable, even if it bypassed certain policies, because it followed the terms of Travelers' settlement with the insured.

On appeal, INA accused Travelers of bad faith, claiming the insurer structured its allocations in such a way to maximize its reinsurance claim. INA seized upon an internal Travelers memo that discussed how to improve Travelers' reinsurance claim in an allocation agreement with the insured.

The Third Circuit determined, however, that the insurer was under no obligation to curtail its reinsurance recovery, burnishing the authority of the follow the fortunes doctrine in post-settlement allocations.

It wasn't a clean sweep for Travelers, though, as the appeals court ruled that the policies at issue provided for a single occurrence limited for the three-year policy, faulting Travelers for annualizing the limits and effectively tripling its coverage.

David Attisani, head of the insurance practice group at Choate Hall & Stewart LLP, said the most interesting aspect of the Third Circuit's decision was the panel's "somewhat unusual gloss" on the traditional follow the fortunes standard, both of which appeared in the opinion.

In the post-settlement allocation context, the Third Circuit tweaked the established standard, saying that a reinsurer must provide direct evidence that the ceding company was motivated primarily by reinsurance considerations or show that the insurer's explanations for its decisions are not credible.

"It remains to be seen whether this gloss will fall by the wayside, as an idiosyncrasy of this particular opinion, or whether other courts might bring it into the lexicon of descriptive language used to interpret the follow the settlements principle," Attisani said.

Ostrager said that insurers found a considerable amount of comfort in the year's big cases, singling out the Travelers decision for the splash it made in the reinsurance context.

"Reinsurers have increasingly questioned the status of the follow the settlements doctrine in post-settlement allocations, and the Third Circuit panel reinforced the doctrine, showing no great inclination to overturn cedent allocations," Ostrager said.

Travelers is represented by Budd Larner PC.

INA is represented by Mound Cotton Wollan & Greengrass.

The case is Travelers Casualty Co. v. Insurance Co. of North America, case numbers 06-4100, 06-4101, 07-4690 and 08-1032, in the U.S. Court of Appeals for the Third Circuit.

Scandinavian Reinsurance Co. Ltd. v. St. Paul Fire & Marine Insurance Co. et al.

The year 2010 proved that arbitration proceedings no longer receive the deference they formerly enjoyed, with insurers increasingly game to challenge the conduct of arbitrators and confront possible conflicts arising from such proceedings, according to Attisani.

While there were no more than three principal cases in 2009 dealing with insurance arbitration, seven came to the fore in the past year, giving rise to three major decisions. The escalation traces the rising inclination to test arbitration decisions in the courts and the judiciary's own willingness to examine those proceedings, Attisani said.

In February, Judge Shira A. Scheindlin of the U.S. District Court for the Southern District of New York typified this emerging trend when she vacated St. Paul Fire and Marine Insurance Co.'s arbitration award in a dispute with Scandinavian Re, saying the arbitrators failed to disclose their involvement in a related proceeding.

Judge Scheindlin invalidated the award and ordered a stop-loss agreement for arbitration with a new panel after concluding that the arbitrators should have told the parties they served together in a parallel proceeding involving Platinum Underwriters Bermuda Ltd., St. Paul's successor.

The court found that arbitrators concealed relationships that were material to the Scandinavian Re dispute, raising the specter of impartiality. Specifically, the arbitrators didn't mention that a former executive at Scandinavian who testified as a witness in the company's arbitration was also a key witness in the Platinum case.

In a case involving John Hancock Life Insurance Co. in the U.S. District Court for the Northern District of Illinois, a judge disqualified an arbitrator for serving in two successive arbitrations involving the same parties and the same reinsurance contracts.

While arbitrators are generally granted deference and trusted to be impartial despite previous experiences, the court found that Hancock's chosen arbitrator could not participate in the second proceeding without violating the confidentiality agreement from the first dispute.

"The rule for decades has been that you can't mount a challenge to arbitrator conduct until an award is issued, but now courts have shown greater willingness to scrutinize disclosures among other things, and, on the balance, challenges have been more successful," Attisani said.

The practical effect of these decisions is to put arbitrator disclosures and relationships under the microscope in what is already an insular and close-knit legal community.

"Arbitration proceedings are no longer afforded the wide berth they used to get, and legal and contractual standards for umpire and arbitrator conduct are, in general, being evaluated with greater care by participants in the arbitral process, who are eager to avoid censure from the courts," Attisani said.

The relative success of these challenges has also whetted an appetite to solicit judicial involvement on the front end, before the issuance of an arbitration award, Attisani said

Scandinavian Re is represented in the case by Akin Gump Strauss Hauer & Feld LLP.

St. Paul is represented by Chadbourne & Parke LLP.

The case is Scandinavian Reinsurance Co. Ltd. v. St. Paul Fire & Marine Insurance Co. et al., case number 1:09-cv-09531, in the U.S. District Court for the Southern District of New York.

Pendergest-Holt v. Certain Underwriters at Lloyd's of London et al.

Cautionary tales abound in the R. Allen Stanford investment imbroglio, including the perils of trusting certificates of deposit. But insurance lawyers said the litigation against Stanford and his cronies has spotlighted the precariousness of directors and officers policies.

In October, Judge Nancy F. Atlas of the U.S. District Court for the Southern District of Texas left Stanford and two other former bigwigs at Stanford Financial Group without defense coverage, after holding a preliminary fact finding hearing to determine whether their conduct excluded coverage.

The insurance tug-of-war played out in unusual circumstances, with the U.S. Court of Appeals for the Fifth Circuit ultimately finding that Lloyd's was obligated to pay defense costs under the D&O policy unless a court made an in fact determination that money laundering as defined by the policy had occurred.

The policy contained a rare money laundering exclusion, which nixed coverage of defense costs for conduct much broader than the simple violation of a money laundering statute.

On remand from Fifth Circuit, the district court held a hearing at which the Stanford defendants invariably pled the Fifth Amendment against incriminating themselves. It ultimately found that the Lloyd's policy did not in fact obligate coverage.

While the Stanford case is a particularly lurid one, involving an alleged $8 billion Ponzi scheme and an immense financial network, the case offers policyholders a valuable and daunting lesson about how difficult attaining D&O coverage can be, both Daniel Struck and Neil Posner of Much Shelist Denenberg Ament & Rubenstein PC said.

"The Stanford dispute illustrates just how complex a task it is to secure defense in a complicated D&O matter where criminal allegations are in play," Struck said. "Policyholders must pay extremely close attention when placing the policies and work to secure the most favorable possible terms in advance, otherwise they could well find themselves stripped of coverage when they need it most."

Although the Stanford debacle is writ large and centers on egregious conduct, the coverage hinged on the fine print of the

policy. Therefore the case is acutely relevant and might even anticipate future cases as insurers learn from the triumph of Lloyd's, Posner said.

"Just because Stanford is an exceptional case doesn't mean it doesn't teach a broadly applicable lesson," Posner said. "It

drives home to policyholders the importance of insisting on 'final adjudication' language when they are negotiating to buy D&O coverage."

The Stanford case makes clear that directors, officers, companies and insurers must minutely review proposed D&O policies and pin down language governing the way that facts giving rise to an exclusion are established, Posner said.

Lloyd's is represented by Akin Gump Strauss Hauer & Feld LLP.

The case is Pendergest-Holt v. Certain Underwriters at Lloyd's of London, et al., case number 09-3712, in the U.S. District Court for the Southern District of Texas.

Travco Insurance Co. v. Ward

Numerous cases are pending across the U.S. over whether commercial liability and other insurance policies include coverage for claims stemming from Chinese-made drywall, which was widely used in rebuilding efforts following recent hurricanes.

The drywall allegedly emits noxious chemical gases, causing health problems in homeowners and corroding building components, including wiring and HVAC systems. Insurers have widely cited pollution exclusions, among other provisions, in denying related claims.

While insurance decisions have gone both ways, insurers got a heartening — and perhaps trend-setting — ruling in June from the U.S. District Court for the Eastern District of Virginia, in Travco Insurance Co. v. Ward.

The homeowner in the case argued that the pollution exclusion did not apply because the Chinese drywall was not regarded as an environmental pollutant, but Judge Robert Doumar construed the category more broadly, finding that sulfuric gases rated as a pollutant according to the policy terms.

Dealing a combination blow to the homeowner, the court also ruled that the losses from defective drywall fell within the latent-defect exclusion because defects in the chemical composition of the drywall damaged other parts of the residence.

Further, Judge Doumar found that the faulty-materials exclusion also applied and precluded coverage for damages resulting from the drywall. And in a final salting of the wound, the court concluded that the homeowner claims for damages were nixed by the exclusion for loss caused by corrosion.

In the decision, the court pointedly criticized an earlier ruling in a Louisiana state court that went against the insurer and found that defective drywall does not in fact fall under a homeowner policy's pollution and defective-planning exclusions.

Ostrager said that the sheer number of Chinese drywall cases and scant rulings on the coverage issues makes the Travco opinion a particularly forceful win for insurers, as other courts are bound to view it a touchstone.

"The Travco Chinese drywall case demonstrates the continuing vitality of the case law giving broad effect to pollution exclusion clauses," Ostrager said.
The Travco case is pending appeal at the U.S. Court of Appeals for the Fourth Circuit.

Travco is represented by Hancock Daniel Johnson & Nagle PC and Robinson & Cole LLP.

Larry Ward is represented by Breit Drescher & Imprevento PC.

The case is Travco Insurance Co. v. Ward, case number 2:10-cv-00014, in the U.S. District Court for the Eastern District of Virginia.

Federal Deposit Insurance Corp. v. Great American Insurance Co.

The havoc caused by the recent financial crisis includes countless lawsuits, and the failure of roughly 200 banks will doubtless prove a particularly plentiful source of litigation, with much of it focused on the insurance policies in play.

The U.S. Court of Appeals for the Second Circuit's opinion in the Federal Deposit Insurance Corp's case against Great American Insurance Co. provides an informative cautionary tale about the potential obstacles as courts try to decide the extent to which receivers are entitled to failed banks' insurance assets, according to Struck..

The dispute stems from Connecticut Bank of Commerce's acquisition of the much larger MTB Bank in 2000. The CBC executives allegedly cooked the books in order to secure the transaction, borrowing money from MTB through intermediaries and using the borrowed funds as capital.

State regulators shut the bank down in 2002 and put the bank's assets under the authority of the FDIC. The agency sued Great American in 2006 for breach of contract after the insurer rescinded a fidelity bond, claiming material misrepresentations on CBC's insurance application nixed all coverage related to the loan scheme.

After the CBC acquired MTB, Lloyd's declined to renew the MTB policy, concerned over claims MTB had made relating to a fraudulent invoicing and the indictment of senior executives in an importing conspiracy.

However, on the insurance application with GAIC, CBC glossed over the fact that Lloyd's backed out of renewing and omitted mention of the scandals that caused Lloyd's to balk.

The Second Circuit concluded that GAIC would not have offered to insure CBC but for the omissions and that the insurer was therefore entitled to rescind coverage for the FDIC.

"The Second Circuit's ruling provides a warning as receivers and insurers come to vie over the status of insurance policies and more fights over the assets of failed banks make it to the courts," Struck said. "The decision represents a signpost for the kinds of risks that lie ahead."

The FDIC is represented in the matter by Roy Kiesel Keegan & DeNicola PLC.

Great American is represented by Eckert Seamans Cherin & Mellott LLC, Ballard Spahr Andrews & Ingersoll LLP and the Law Offices of Margaret A. Little.

The case is Travco Insurance Co. v. Ward, case number 2:10-cv-00014, in the U.S. District Court for the Eastern District of Virginia.