CPCU SOCIETY INSURING YOUR SUCCESS

Underwriting Trends

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Chairman's Corner

by J. Brian Murphy, CPCU, ARM, ARe, AMIM

J. Brian Murphy, CPCU, ARM, ARe, AMIM, is vice president of reinsurance for Brokers' Risk Placement Service, a managing general underwriter and reinsurance intermediary located in Chicago. His responsibilities include the marketing and placement of reinsurance for commercial clients. His experience includes underwriting roles in two of the largest commercial insurers spanning more than 25 years, and recently on the brokerage side of the business.

Murphy received his bachelor of arts degree from Central Connecticut State University, and his master of arts from the University of Connecticut, both in economics. He frequently teaches the Insurance Institute of America's General Insurance (INS) course to new members of the insurance community. He serves on the board of the Association of Lloyd's Brokers, which provides information, education, and business contacts to Lloyd's correspondents and coverholders in Illinois.

Murphy also serves on the board of the Elmhurst City Centre in Elmhurst, IL; is a director of the CPCU Society's Chicago Chapter; and is the new chairman of the CPCU Society's Underwriting Section Committee.

The Underwriting Section Committee met on April 21, 2007, at the CPCU Society's Leadership Summit in Orlando. Much of the meeting was devoted to preparations for the CPCU Society's Annual Meeting and Seminars in Hawaii on September 8–11. The Underwriting Section will sponsor a seminar entitled, "Decision Management Evolution: Advances in Real-Time, Risk-Driven, Rules-Based Underwriting Decisions," on Monday, September 10. A panel of highly-qualified speakers will share their knowledge on the topic.

In past years we offered an Underwriting Section lunch. This year we are offering a breakfast on Monday, September 10, to accommodate those who will be attending seminars or sight seeing in the afternoon. As always, we will have a nice gift for each breakfast attendee.

If you are planning to attend the CPCU Society's Annual Meeting and Seminars, please join us at the Underwriting Section seminar and breakfast.

On March 22, 2007, the Underwriting Section held the CPCU Society's first webinar on "Emerging Issues in Insurance Coverage." This webinar was offered exclusively to Underwriting Section members as a benefit of membership, and we had 100 register for this opportunity. Domenick J. Yezzi, CPCU, vice president of specialty commercial lines for ISO was the speaker, and Nancy Cahill, CPCU, was the moderator. The topics addressed were nanotechnology, food litigation/GMOs, and electromagnetic fields. Based on the evaluations from members, the webinar was very effective. This was a "pilot" webinar; we are considering offering another one later in the year. A special thanks is owed to Connor M. Harrison, CPCU, and the AICPCU for underwriting the cost of the technology that made the webinar possible.

We are always looking for articles for *Underwriting Trends*; if you or someone in your organization has an article they would like to publish, please contact Gregory J. Massey, CPCU, CIC, CRM, ARM, PMP, at greg.massey@selective.com or Stephen W. White, CPCU, at steve.white.bnbg@statefarm.com.

We still have vacancies on the Underwriting Section Committee and are seeking volunteers. The commitment entails attendance at the Leadership Summit in April, and the CPCU Society's Annual Meeting and Seminars in September. If you are interested in learning more about this, please contact me at murphyb@brps.com. ■

What's In This Issue

Underwriting Section Presents the CPCU Society's First Webinar

The CPCU Society's first webinar was hosted by the Underwriting Section on March 22, 2007. Given the popular topic, "Emerging Issues in Insurance Coverage," it was no surprise that nearly 100 people registered for this event. If you have suggestions for future webinars, or are interested in presenting a topic, please contact one of the Underwriting Section Committee members.

The presenter was **Domenick J. Yezzi, CPCU,** a vice president at ISO. **Nancy Cahill, CPCU,** a project manager with Liberty Mutual Agency Markets, was the moderator.

The agenda included three emerging topics:

- nanotechnology
- food litigation/genetically modified organisms (GMOs)
- electromagnetic fields (EMFs)

Nanotechnology

This growing body of science was founded on the concept of building or enhancing products, processes, and machines at the molecular level. Molecular level takes on many forms; however, to draw an analogy of how small we're talking about, splitting a human hair 80,000 times will give you the width of one nanometer.

Today there are more than 1,700 firms from 34 countries involved in this field (and it is growing). More than two million U.S. workers are exposed to nanomaterial particles on a regular basis. Early predictions show that there could be more than two million people directly employed in 10 years producing products containing nano-materials approaching $2.6 trillion! Existing products include skin creams and cosmetics, sun lotions, pigments and coatings, computer chips, fabrics/clothing, sports equipment, and electronics.

Consider the positives with this technology . . .

- Allow us to snap together the fundamental building blocks of nature easily, inexpensively, and in most of the ways permitted by the laws of physics.
- Allow for advances in technology.
- Change existing products or fabricate an entire new generation of products that are cleaner, stronger, lighter, and more precise.
- Replacement of fossil fuel with super-efficient hydrogen-based fuel cells.
- Medical nano-robots . . . devices the size of a microbe, incapable of self-replication, containing onboard sensors, computers, manipulators, etc., with the ability to cure known diseases and accelerated tissue repair due to physical injuries. This will result in extending human life span.
- Materials 100 times stronger but one-sixth the weight of steel.
- Materials used to filter and remediate contamination.

There is growing concern with this technology, which includes possible unexpected and unknown consequences. Given the elements are so small, they could conceivably slip through the cell membrane and cause molecular damage. Also, consider these tiny particles remaining airborne for long periods of time, and the possible damage through the respiratory system. Concern is also along the lines of natural resource damage and products/premises impact.

Food Litigation

Consider this quote from John Banzhaf III of George Washington University, "Legal action is one of the best ways to combat the national obesity epidemic." And that's exactly what we're reading about in the newspapers. Some may have thought that the food litigation was going down the path of the tobacco products; however, consider the following points in comparing the two products:

- Cigarettes, used as intended, are deadly (food is healthy when used appropriately).
- Cigarettes are not a necessity (food is essential for survival).
- Smokers consistently choose a single brand (most people eat a wide variety of food; thus it is difficult to tie down the specific product source of obesity).
- Nicotine fits all the criteria for addiction (food does not).

Legislators are keenly aware of the costs of obesity, such as: the leading cause of preventable death; contributing to these top medical spending conditions, arthritis, asthma, back problems, diabetes, and heart disease; significantly higher medical costs and absenteeism rates for workers who are obese versus those who are not. Given this knowledge, laws have been passed to address nutritional standards on school meals and to limit types of foods that can be sold during school hours (including soft drinks in vending machines). The so-called "cheeseburger laws" have also evolved whereas you're responsible for what you eat (as long as you aren't misled).

While common-sense consumption laws prevent lawsuits tying obesity to the restaurant industry, state laws are aimed at the central issue of personal responsibility and common sense. Opponents, however, indicate that deception in advertising and manufacturers not properly labeling important product information are contributing factors.

Genetically Modified Organisms (GMOs)

GMOs are any life form where the DNA has been altered for specific purposes, such as: research; manufacturing of animal proteins; to correct genetic defects; to increase farm product yields or enhance taste; food shape, such as rounder potatoes for easier processing; to resist disease; pesticide tolerant; frost resistant; delayed ripening; to produce industrial detergents. Approximately 70 percent of grocery store food may be biotechnology crops.

The concerns include:

- Unknown effects on human health and other organisms, such as weakening of immune systems or exposure to toxins and allergens.
- Unintended transfer of transgenes through cross-pollination (super weeds).
- Loss of flora and fauna biodiversity (toxic to beneficial insects).
- Domination of world food production by a few companies.
- Labeling not mandatory in the United States.

EMFs

This area dealt primarily with cell phone use and, while many studies have been done, the verdict is inconclusive thus far. Cell phones were initially almost exclusively used for business; however, consumers have been using the phones for an average of seven years. Many health risks take in excess of 10 years to appear. ■

Get Exposed!

We're always looking for quality article content for the Underwriting Section newsletter. If you, or someone you know, has knowledge in a given insurance area that could be shared with other insurance professionals, we're interested in talking with you. Don't worry about not being a journalism major, we have folks who can arrange and edit the content to "publication-ready" status. Here are some benefits of being a contributing writer to the Underwriting Section newsletter:

- Share knowledge with other insurance professionals.
- Gain exposure as a thought leader or authority on a given subject.
- Expand your networking base.
- Overall career development.

To jump on this opportunity, please e-mail either Stephen W. White, CPCU, at steve.white.bnbg@statefarm.com or Gregory J. Massey, CPCU, CIC, CRM, ARM, PMP, at greg.massey@selective.com.

CPCU SOCIETY INSURING YOUR SUCCESS

you underwriting

UNDERWRITING SECTION

The Underwriting Section Committee

We put the YOU in underwriting.

The importance of this slogan is that insurance is still a people and relationship business. People make the difference.

Make sure to put the YOU in the underwriting process.

Growing Appreciation of EPL Exposures

by Brooke Rockefeller, CPCU, ARe, RPLU

Brooke Rockefeller, CPCU, ARe, RPLU, is a vice president of treaty marketing and has been with Gen Re for more than 16 years. Her primary role is developing property and casualty treaties in the midwest United States. In addition to her treaty account responsibilities, she is the business development specialist for employment practices liability insurance, which includes marketing and product responsibility for the line of business. Also, Rockefeller runs the training and development program for the treaty group, and plays a significant role in strategic planning for the department.

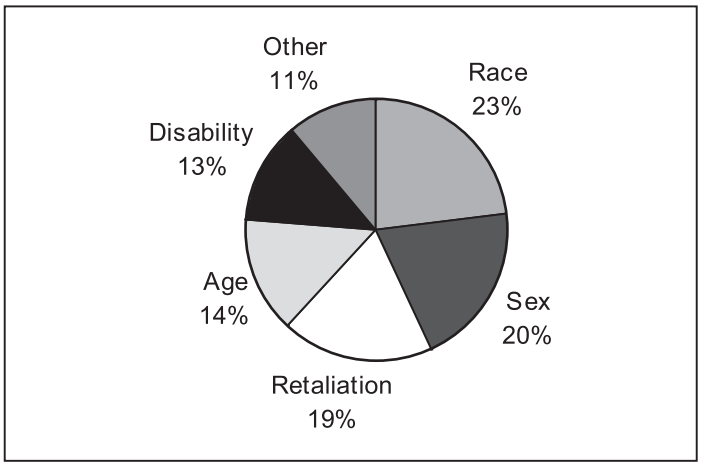
Prior to joining the treaty group, Rockefeller spent nine years writing casualty facultative business for Gen Re in Dallas and Philadelphia. She worked as a sales representative for Xerox in Baltimore before joining the reinsurance industry. Rockefeller received her M.B.A. in finance from Villanova University and a B.A. in economics from Lehigh University.

Editor's note: This article was reprinted with permission from the author.

Did you know that employment and labor lawsuits are the number-one litigation fear of corporate counsel? In a 2006 survey completed by Fulbright & Jaworski, 54 percent of in-house counsel identified labor/employment disputes as their top concern, ahead of contract, regulatory, patent, and class-action disputes. Moreover, the concern over employment litigation is almost double than from one year ago.

A healthy fear of employment and labor lawsuits might not resonate so highly with this survey group without actual loss experience. The latest annual survey captures that experience: labor/employment issues generated more class-action lawsuits than securities, environmental, and other common corporate exposures.

Figure 1
EEOC Discrimination Complaints (Based on EEOC Data)



While the law firm survey reflects the views of large companies that are more often litigation targets than small employers, there are many reasons for small employers to be concerned about employment liability, too. Firms with only a few employees have exposures, and even a small verdict can strain the budget. The growing number and complexity of employment laws can confound any company. Therefore, all types and sizes of employers have many reasons to buy EPL insurance.

Employment Law Trends

Workforce issues generate a wide variety of EEOC complaints and litigation. Discrimination based on race, sex, and age comprise more than half the total complaints filed with the EEOC, as they have for the past 14 years when the EEOC began reporting its enforcement statistics. Religion and national origin discrimination claims have increased since 9/11. In contrast, the EEOC reports a decline in disability complaints over this same time period.

Retaliation claims stand out for how much they have grown, and are likely to grow in the future. The number of retaliation charges jumped from roughly 11,100 in 1992 to 22,300 in 2005—more than a 100 percent increase. Many retaliation claims grow out of allegations of discrimination, union or safety violations, harassment, or other workplace wrongs. Even if there is no validity to the original complaint, the employer can still violate the retaliation law by how it reacts. With a broader definition of retaliation under a 2006 U.S. Supreme Court opinion, we anticipate even stronger growth in claim activity. (See Figure 1.)

Federal complaints filed with the EEOC are the tip of the iceberg. More complaints go directly to court, or state labor commissions, and involve state laws, some of which are stricter than their federal counterparts. For example, the Michigan civil rights law applies to companies with only one employee; the federal statute does not attach until the company reaches 15 employees. On average, states enforce more than 10 state employment laws—Illinois has as many as 19, New York has 18—that are stronger, weaker, or identical to the federal laws. Common-law claims for defamation and invasion of privacy add to the litigation volume.

No Companies Are Immune

Many small employers lack the resources to assure full compliance with the battery of employment laws. In-house human resource and legal staff may be limited or nonexistent. Outside consultants and

Table 1
Federal and State Statutes of Michigan Law (Partial Listing)

Number of Employees	Applicable Statute
1 or more	• Equal Pay Act • MI Civil Rights Act • MI Whistleblower Act • MI Disabilities Civil Rights Act
15 or more	• Civil Rights Act (Title VII) • Americans with Disabilities Act • Pregnancy Discrimination Act
20 or more	• Family and Medical Leave Act

counsel may help with specific problems, but budgets may preclude everyday involvement. Small employers may not have the size to justify compliance staff, but they operate subject to most employment statutes (see Table 1). In other words, they have exposure without commensurate protection. Small employers may not be the target of class actions and million-dollar verdicts, but they are exposed to EPL claims. Gen Re tracks reported verdicts and settlements by company size, industry, state, and loss amount. We have discovered that employers with fewer than 25 employees are well represented in the loss experience data, despite the fact that they may tend to downplay any exposure. Based on our limited sample, we count close to 700 verdicts or settlements with damages awarded against employers in this "small" size segment, most in the $25,000 to $200,000 range. Medical offices, printing companies, contractors, schools . . . they are all there.

Selling the Coverage

One of the greatest sales challenges is overcoming company perceptions that EPL suits could never happen to them. Perhaps most of the employers in the 700 verdicts or settlements in our database felt that way at one time. Educating customers about the complexity of employment risks and the reality of lawsuits can help insurers clear the hurdle.

Concerns about employment and labor suits are justified for most companies, and so is the purchase of EPL insurance. The courts and legislatures keep giving us reasons. ■

Thought to Ponder . . .

"The greatest mistake you can make in life is to be continually fearing you will make one."

—**Elbert Hubbard**
an American philosopher and writer

Don't Miss Your Underwriting Section's Seminar and Breakfast at the 2007 Annual Meeting and Seminars in Honolulu

Decision Management: Advances in Real-Time, Risk-Driven, Rules-Based Underwriting Decisions

Monday, September 10
10:45 a.m. – 12:45 p.m.

Learn from an industry leader in the development of rules-based, predictive model-enhanced, decision systems and from underwriting executives who have implemented new underwriting decision strategies based on these systems. While the decision tools are readily available for underwriting, claims, and new product offerings within property and casualty, life, and specialty insurance, this seminar will focus on the real benefits seen by two insurers focused on enhancing and advancing their underwriting practices. Developed by the Underwriting Section

Moderator
Lamont D. Boyd, CPCU, AIM
Fair Isaac Corporation

Presenters
Ian H. Turvill
Fair Isaac Corporation

Michael W. Koscielny Jr., CPCU, CIC
American Modern Insurance Group

Patrick J. Madigan
Unitrin Kemper Auto and Home

Underwriting Section Breakfast

Monday, September 10
7 – 8:30 a.m.

Register today at www.cpcusociety.org.

Coverage Gone Mild: Sixth Annual Look Back at the Year's 10 Most Significant Insurance Coverage Decisions

by Randy J. Maniloff

Randy J. Maniloff is a partner in the business insurance practice group at White and Williams, LLP in Philadelphia. He concentrates his practice in the representation of insurers in coverage disputes over primary and excess policy obligations for various types of claims, including construction defect, mold, general liability (products/premises), environmental property damage, asbestos/silica, and other toxic torts, first-party property, homeowners, director's and officer's liability, a variety of professional liability exposures, including medical malpractice, media liability, community associations, public official's liability, school board liability, police liability, computer technology liability, managed care, and additional insured/contractual indemnity issues.

The views expressed herein are solely those of the author and are not necessarily those of his firm or its clients. The author expresses his appreciation to firm associate Brad Pollack for his invaluable assistance with the preparation of this article.

Editor's note: The following article is an "excerpt" from the author's 23-page article that appeared in the January 9, 2007, issue of *Mealey's Litigation Report –Insurance*. Please feel free to contact the author for a copy of the full article at maniloffr@whiteandwilliams.com.

The article presented here will discuss the top 10 cases and provide the full discussion on three of the cases that we thought would be of most interest to the majority of the *Underwriting Trends* readers.

While normally more fun than a barrel of monkeys, in 2006, insurance coverage was more like a couple of goldfish in a bowl. As hard to believe as it is, the heretics who claim that coverage can be a little bland enjoyed a rare I-told-you-so moment last year. Well, even a broken clock is right twice a day.

So how could this have happened? In 2006, the nation's highest state courts seemed to serve more decisions than usual addressing meat and potatoes coverage issues. Some years these courts pepper the basics with fusion cuisine. This wasn't one of them. Not to say that the buffet wasn't satisfying; the fare was simply claim vanilla. And since this annual insurance coverage year-in-review is usually cooked up with dish-isions selected from high court menus, it took a little extra foraging to find the tasty morsels. Thankfully, it wasn't a complete famine and there were still a few things to chew on. The coverage world didn't lay a complete egg.[1]

The following 10 coverage decisions are from the smorgasbord of the year gone by that are likely to play a significant part in setting the insurance coverage table in the years ahead.

The selection process operates throughout the year to identify coverage decisions that are most likely to impact a large number of subsequent claims. Those chosen usually, but not always, hail from state high courts and may (1) involve a frequently occurring claim scenario that has not been the subject of many, or clear-cut, decisions; (2) alter a previously held view on a coverage issue; or (3) involve a burgeoning coverage issue. The process is highly unscientific. There is no point system, blue-ribbon panel, or telephone voting, as in *American Idol*. Much like a dog show, the judging is very subjective, but does not want for hand wringing to narrow the field to those you see here.[2]

The following are the 10 most significant insurance coverage decisions of 2006 (listed in the order that they were decided):

- ***Peninsula Cleaners v Hartford Casualty Insurance Company***—Three years after MacKinnon's yellow jackets severely limited the absolute pollution exclusion, a California District Court (and others in 2006) demonstrated that insurers are not feeling the sting in every case.
- ***Contreras v U.S. Security Insurance Company***—Insurer had two choices and each was bad faith. Florida appeals court addressed whether insurers can get squeezed in the Sunshine State.
- ***French v Assurance Company of America***—Fourth Circuit made toast of a common interpretation of the "subcontractor exception" to the "your work" exclusion.
- ***Brannon v Continental Casualty Company***—Supreme Court of Alaska gave an insurer a chilly reception to its argument that the statute of limitations on an insured's action for breach of the duty to defend began to run from the time of the disclaimer. Two weeks later the Supreme Court of Nebraska did the same.

- ***Patrons Oxford Insurance Company v Harris***—High Court of Maine addressed a coverage issue as old as the state's crustaceans and still with no easy answers: The insured is presented with an opportunity to settle a case and turns to its insurer, which asserts that it has a coverage defense.
- ***Safeco Insurance Company v Superior Court of Los Angeles County***—A California appeals court addressed the burden of proof in an important contribution context. The result—more insurers can now share the burden of construction defect settlements.
- ***Guideone Elite Insurance Company v Fielder Road Baptist Church***—Don't Mess with the Duty to Defend. Supreme Court of Texas refused to consider facts outside the complaint to extinguish an insurer's duty to defend. Pennsylvania Supreme Court did the same in refusing to create a duty to defend.
- ***The Standard Fire Insurance Co. v The Spectrum Community Association***—A California appeals court added a sub-plot to insurance law's greatest work of fiction: the continuous trigger.
- ***Fiess v State Farm Lloyds***—In a long-awaited decision, the Supreme Court of Texas sang Mold Lang Syne to policyholders in many circumstances.
- ***Valley Forge Insurance Company v Swiderski Electronics, Inc.***—Face the fax: Supreme Court of Illinois transmitted an important win for policyholders in the most significant Telephone Consumer Protection Act coverage decision to date.

Significant Insurance Coverage Decisions of 2006

French v Assurance Company of America, 448 F.3d 693 (4th Cir. 2006).

The number of decisions in 2006 addressing coverage for construction defects—including at the state high court level—was staggering. And more are on the way, based on certified questions that are in the works. The question whether faulty workmanship or breach of contract constitutes an "occurrence" is the latest great debate in the coverage world. Indeed, three of the 10 cases discussed in this commentary are related to construction defect. It is unfortunate that the situation has reached this point.

Consider this. When it comes to claims for latent injury and damage, such as asbestos and hazardous waste, they were never contemplated under the historic policies that were called upon decades later to respond. That being so, it is not surprising that questions such as trigger and allocation were viewed by courts as particularly vexing, with the result being the development of different schools of thought in response to the issues. But claims for coverage for construction defects and the damage they cause are much different. It is unquestionably contemplated that such claims will be made under commercial general liability policies, especially when the insured has the word "contractor" in its name. Thus, it is unfortunate and unnecessary that so much disparity and confusion are developing in case law over the treatment of such claims, especially those involving relatively similar facts and often-times identical policy language.

In *French*, the Fourth Circuit was confronted with routine facts in a construction defect coverage case. In 1993, the Frenches contracted with Jeffco Development Corporation for the construction of a single-family chalet in Fairfax County, Virginia. Pursuant to the construction contract, *and via a subcontractor*, the exterior of the home was clad with a synthetic stucco system known as Exterior Insulating Finishing System, and even better known as EIFS. A Certificate of Occupancy for the Frenches' home was issued in December 1994. In 1999, the Frenches discovered extensive moisture and water damage to the otherwise nondefective structure and walls of their home resulting from defects in the EIFS. The Frenches spent in excess of $500,000 to correct the defects in the EIFS and to remedy the resulting damage to the otherwise nondefective structure and walls of their home. *French* at 696.

The Frenches filed suit against Jeffco alleging multiple claims, including breach of contract, and sought damages to cover the costs to correct the defects to the EIFS and to remedy the resulting damage to the otherwise nondefective structure and walls. *Id.*

The Frenches' suit gave rise to claims by Jeffco for coverage from four commercial general liability insurers. Three of the CGL insurers agreed to defend Jeffco and one declined. Just before trial, the Frenches and Jeffco reached a settlement. The settlement included a confession of judgment by Jeffco and the assignment by Jeffco to the Frenches of Jeffco's rights under certain policies. The Frenches, as assignees of Jeffco's rights, brought suit against two of the insurers. *French* at 698–699.

Cross motions for summary judgment ensued and the District Court of Virginia, applying Maryland law, granted summary judgment for the insurers and denied the Frenches' motion for partial summary judgment. The District Court relied on *Lerner Corp. v Assurance Co. of Am.*, 707 A.2d 906 (Md. Ct. Spec. App. 1998), in concluding that no coverage existed under the policies pursuant to the express exclusion of coverage for property damage expected or intended from the standpoint of the insured. *French* at 699.

The parties marched on to the Fourth Circuit, which held that the District Court was half right:

> We hold that, under Maryland law, a standard 1986 commercial general liability policy form published by the ISO does not provide liability coverage to a general contractor to correct defective workmanship performed by a subcontractor. We also hold that, under Maryland law, the same policy form provides liability coverage for the cost to remedy unexpected and unintended property damage to the contractor's otherwise nondefective work-product caused by the subcontractor's defective workmanship. With respect to this last holding, we assume arguendo that no

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other policy exclusion applies. *French* at 706.

Thus, the Fourth Circuit held that the costs to correct the defective EIFS were not covered, but coverage was available for damage to the nondefective structure and walls of the Frenches' home that resulted from moisture intrusion through the defective EIFS.

On its face, there is nothing remarkable about the Fourth Circuit's decision. Courts addressing coverage for construction defects routinely draw a distinction between noncovered damage *to* an insured's work versus damage *caused* by an insured's work, for which coverage is available.

But the Fourth Circuit's decision in *French* was a little different. There, the EIFS was installed by a subcontractor of the insured-general contractor, Jeffco. In a situation like this, it is not uncommon for those involved in construction defect coverage matters to point to the involvement of a subcontractor as the basis to depart from the ordinary rule that coverage is unavailable for damage to an insured's work. As such, the argument is now often made that coverage exists to correct defects in a subcontractor's work. The asserted basis for this departure is the "subcontractor exception" to the "your work" exclusion, which provides as follows:

> l. Damage to Your Work
> "Property damage" to "your work" arising out of it or any part of it and included in the "products-completed operations hazard."
>
> This exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor.

However, the flaw in this argument is that the *subcontractor exception to the your work exclusion* is not called the subcontractor exception to the occurrence requirement. The *French* court recognized this and concluded that, notwithstanding that the EIFS was defectively installed by a subcontractor, such defective application does not constitute an accident, and, therefore, is not an occurrence under the CGL policy. The court reviewed the history of the development of the CGL policy's "subcontractor exception" to the "your work" exclusion before arriving at this conclusion. Therefore, coverage was unavailable for the costs to correct the defective EIFS—*subcontractor or no subcontractor*.

In the interest of being fair and balanced, see *Great American Insurance Company v Woodside Homes Corporation*, 2006 U.S. Dist. LEXIS 61453 (D. Utah), a 2006 decision that rejected this argument and held that negligent acts by an insured's subcontractor can constitute an "occurrence."

Patrons Oxford Insurance Company v Harris, et al., 2006 ME 72, 905 A.2d 819 (Me. 2006).

It is a frequently occurring scenario. An insurer is defending its insured under a reservation of rights. The insured is presented with an opportunity to settle the case within its limits of liability and would like to do so. The insurer has either not filed a declaratory judgment action to have its coverage issue(s) resolved or, if it has filed such an action, a decision will not come in time. The tension is thick. By settling, the insured can eliminate the uncertainties of trial and the risk of a verdict greater—and possibly much greater—than its coverage limits. The insurer also wants to eliminate the risk of an excess verdict, but is confronted with uncertainty over its coverage obligation and is entitled to limit such obligation to only claims that are within the confines of its policy.

Despite the frequency in which this coverage drama plays out, it has not been addressed by a significant number of courts—at least not as many as one would expect. Moreover, the decisions that have addressed the issue are not consistent, sometimes leave questions unanswered, and may also create collateral issues. For example, this situation gives rise to questions whether an insurer can settle the underlying action and then seek reimbursement if it is determined that no coverage was owed. And what about if certain damages in the settlement may be covered while others are not.[3] On a related front, if a case being defended under a reservation of rights is headed to trial, questions sometimes arise whether the insurer (1) can intervene in the underlying action; (2) can require the use of special jury interrogatories to have its coverage issue(s) resolved; and (3) is estopped from litigating facts in a coverage action that were determined in the underlying action. And the list goes on.

Incidentally, last year's installment of the 10 Most Significant Insurance Coverage Decisions of the Year included *Excess Underwriters at Lloyd's, London v Frank's Casing Crew & Rental Tools, Inc.*, 2005 Tex. LEXIS 418, in which the Texas Supreme Court addressed whether an insurer can settle a claim and then seek reimbursement from its insured if it is later determined that no coverage was owed. The *Frank's Casing* court held that, under the following circumstances, an insurer has a right to reimbursement if it has timely asserted a reservation of rights, notified the insured that it intends to seek reimbursement and paid to settle claims that were not covered: (1) when an insured has demanded that its insurer accept a settlement offer that is within policy limits; or (2) when an insured expressly agrees that the settlement offer should be accepted. *Frank's Casing* at *11. Despite issuing a decision that was obviously not on an impulse—it included a majority and three concurring opinions—on January 6, 2006, the Supreme Court of Texas granted rehearing in *Frank's Casing*.[4]

Back to *Patrons Oxford*, where the Supreme Judicial Court of Maine addressed coverage for an insured's settlement under the following circumstances. Preston

Harris was the driver of a truck that hit Darrell Luce Jr. The truck was owned and insured by David Ferguson, the father of Kurt Ferguson. Harris and Kurt Ferguson arrived at a party and were confronted by a hostile crowd that demanded that they depart or else be physically harmed. They quickly reentered the truck. The crowd physically ushered Harris into the driver's seat and Ferguson into the passenger's seat. In a panic, Harris drove away from the potentially violent crowd and hit Luce, pinning him against another vehicle. *Patrons Oxford* at 822.

Luce brought suit against Harris. Patrons Oxford undertook Harris's defense, subject to a reservation of rights, as there was a question whether Harris had permission to operate the truck.[5] Patrons Oxford filed a motion to intervene in *Luce v Harris*, as well as a declaratory judgment complaint. Luce and Harris filed a stipulation for entry of judgment, with Luce agreeing not to collect a judgment from Harris personally. Luce would attempt to collect a judgment only from Patrons Oxford through Maine's reach and apply statute, if coverage was found. The parties also agreed that the trial court would determine Luce's damages. Judgment on the stipulation was entered and the court awarded Luce $32,704.68. *Patrons Oxford* at 823.

Following a bench trial, the court in the declaratory judgment action held that "Harris was an insured under the Ferguson policy because the emergency situation and the threat of bodily harm made it reasonable for Harris to believe that he was entitled to operate the vehicle to escape the potentially violent situation, despite being intoxicated and not possessing a valid driver's license." *Id.* at 823–24. The trial court noted that, given the exigency of the situation, there was no time for "extended colloquy" between the two men regarding who should drive. *Patrons Oxford* at 824. This decision was affirmed by the Maine high court. *Patrons Oxford* at 825.

Turning to the heart of the decision, Patrons Oxford argued that it was denied due process because it did not have a meaningful opportunity to litigate Harris's liability or Luce's damages. Noting that it had not previously addressed the tensions that exist between an insurer that reserves the right to deny coverage and the impact of that decision on the insured, the Supreme Judicial Court of Maine went on to do so.

First, the court noted that it agreed "with those courts that have held that 'an insurer who reserves the right to deny coverage cannot control the defense of a lawsuit brought against its insured by an injured party.'" *Patrons Oxford* at 825–26 (citations omitted).[6] On the other hand, the court was not unsympathetic to an insurer that possesses a coverage defense. Nor was the court unmindful of the risk faced by an insurer that "an insured being defended under a reservation might settle for an inflated amount or capitulate to a frivolous case merely to escape exposure or further annoyance." *Patrons Oxford* at 827, quoting *United Services Auto. Assoc. v Morris*, 741 P.2d 246, 253 (Ariz. 1987).

Taking all of these factors into consideration, the *Patrons Oxford* court set forth the following rules addressing the competing interests between an insurer with a coverage defense and a policyholder with a desire to protect its interests through settlement of an action pending against it:

> [A]n insured being defended under a reservation of rights is entitled to enter into a reasonable, noncollusive, nonfraudulent settlement with a claimant, after notice to, but without the consent of, the insurer. The insurer is not bound by any factual stipulations entered as part of the underlying settlement, and is free to litigate the facts of coverage in a declaratory judgment action brought after the settlement is entered. If the insurer prevails on the coverage issue, it is not liable on the settlement. If the insurer does not prevail as to coverage, it may be bound by the settlement, provided the settlement, including the amount of damages, is shown to be fair and reasonable, and free from fraud and collusion. The issues of the fairness and reasonableness of the settlement, as well as whether it is the product of fraud and collusion, may be brought by the insurer in the same action in which it asserts its coverage defense. If the claimant cannot show that the settlement and the damages or the settlement amount are reasonable, the claimant may recover only that portion which he proves to be reasonable. If the claimant cannot prove reasonableness, the insurer is not bound. Likewise, if the settlement is found to be the product of fraud or collusion, the insurer is not bound.
>
> *Patrons Oxford* at 828–829.

While insurers do not like to be told that they are bound by settlements to which they did not consent, the Supreme Judicial Court of Maine did not leave insurers empty-handed either. The court's decision provides insurers with avenues to challenge both coverage and the fairness and reasonableness of the settlement. Moreover, holding that insurers are not bound by any factual stipulations entered as part of an underlying settlement is important, especially if it also means that insurers are not bound by any facts that are determined at the trial of an underlying action that is subject to a reservation of rights.

The effect of *Patrons Oxford* is that insurers will be forced to decide just how strongly they feel about their coverage defenses. An insurer that asserts a reservation of rights at the outset of litigation, but now faces the prospect of a stipulated judgment, finds itself in a rubber-meets-the-road coverage situation. If the insurer does not feel confident that it can prevail on the coverage question, it may determine that its interests are better served by abandoning the reservation of rights and taking over the insured's defense of the underlying action. This is especially so if the court is going to have wide latitude on whether a settlement is "reasonable." On the other hand, an insurer that feels strongly about its coverage defenses can allow the stipulated judgment to proceed, secure in the knowledge that it remains free to litigate its coverage obligation—and avoid all

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liability—as well as having the fall-back position of a hearing to determine the fairness and reasonableness of the settlement, if coverage is determined to be owed.

Did the *Patrons Oxford* court answer every question that can arise in this situation? Probably not. But the court deserves high marks for recognizing and balancing the many competing interests that can arise when an insured has an opportunity to settle a case that its insurer asserts.

Fiess v State Farm Lloyds, 2006 Tex. LEXIS 806.

It was not an easy decision to include the Texas Supreme Court's opinion in *Fiess* as one of the year's 10 most significant. The case involves first-party property coverage. And unlike relatively standard CGL policies, first-party property forms are often subject to variation. For this reason, it's always questionable just how much influence a first-party property coverage decision will have on courts down the road.

But *Fiess* had a lot going for it. The case involves coverage for mold. And on that subject, the Texas Supreme Court's views are entitled to much weight (more so than, say, the Supreme Court of Vermont, or some other cool weather state[7]). Second, the District Court decision in the case, finding no coverage, was rejected by several subsequent courts. With this split on the issue, additional guidance was sorely needed. But it would take a long time for that to come, as the Fifth Circuit chose to certify the issue to the Supreme Court of Texas, which was in no hurry to rule. Thus, all together, the time from the District Court's decision to that of the Texas Supreme Court, including the Fifth Circuit detour along the way, was 39 months—one month longer than the gestation period for an Alpine black salamander (which has the longest gestation period of any animal). And none of this was going unnoticed, as evidenced by the boatload of amicus activity in the case.

But in the end, the real value of *Fiess*, and its reason for inclusion here, is that while the court's decision addressed coverage for mold vis-à-vis the "ensuing loss" clause contained in a Texas Department of Insurance-prescribed Homeowners Form, its applicability may not be so narrow.

At issue in *Fiess* was coverage for flooding caused by Tropical Storm Allison. The Fiesses removed drywall damaged by the flood and discovered black mold growing throughout their house. Subsequent testing determined that the mold was stachybotrys, which made the house dangerous to inhabit. The State Farm Lloyds examiner concluded that, while the flooding caused some of the mold damage, a significant percentage was caused by pre-flood roof leaks, plumbing leaks, heating, air conditioning and ventilation leaks, exterior door leaks, and window leaks. Fiess at *27–*28.

State Farm paid the Fiesses approximately $34,000 for mold remediation necessitated by the pre-flood leaks, but maintained that it was not obligated to pay for mold damage caused by the flood, as the policy explicitly excluded all damage caused by flooding. The Fiesses brought suit. *Fiess* at *28. The dispute was over the interpretation of the following policy exclusion contained in a Texas Homeowner's Form HO-B policy:

> We do not cover loss caused by:
>
> 1. wear and tear, deterioration or loss caused by any quality in property that causes it to damage or destroy itself
> 2. rust, rot, mold or other fungi
> 3. dampness of atmosphere, extremes of temperature
> 4. contamination
> 5. rats, mice, termites, moths or other insects
>
> ***We do cover ensuing loss caused by*** collapse of the building or any part of the building, water damage, or breakage of glass which is part of the building if the loss would otherwise be covered under this policy. *Fiess* at *2–*3 (emphasis added).

At issue before the Supreme Court of Texas was the following Certified Question from the Fifth Circuit: "Does the ensuing loss provision . . . when read in conjunction with the remainder of the policy, provide coverage for mold contamination caused by water damage that is otherwise covered by the policy?" *Fiess* at *2.

The Fiesses argued that the court must disregard how the policy provision starts ("We do not cover loss caused by mold") because of how it ends ("We do cover ensuing loss caused by water damage.") Fiess at *10. The court declined to do so, relying on *Lambros v Standard Fire Insurance Co.*, 530 S.W.2d 138 (Tex. Civ App.—San Antonio 1975, writ ref'd), which held that "water damage must be a consequence, i.e., follow from or be the result of the types of damage enumerated in [the exclusion]." Fiess at *12, quoting *Lambros*.

The *Fiess* court concluded that the "ensuing loss" clause provides coverage only if one of the relatively common and usually minor excluded risks (rust, rot, mold, humidity, wear and tear, etc.) leads to a relatively uncommon and perhaps major loss: building collapse, glass breakage, or water damage. Fiess at 17. The majority criticized the dissent for a construction that would operate to create broader coverage, as more exclusions were added to a policy containing an ensuing loss clause. *Fiess* at *21.

The *Fiess* court stated that:

> [T]he upshot of the dissent's construction would be that the more risks *excluded* in a policy containing an ensuing-loss clause, the *broader* coverage would become. Paragraphs 1(f), 1(g), and 1(h) of the HO-B policy contain roughly 22 exclusions, and each has an ensuing-loss clause listing 3 intervening risks (building collapse, water damage, and glass breakage).

> According to the dissent, if any one of the 22 exclusions combines with any one of the 3 intervening risks to cause any of the 22 excluded losses, the loss is no longer excluded. This would mean there are only about 1,452 possible ways to turn exclusions into coverage. Thus, the more exclusions that are added, the broader coverage gets. This cannot possibly be a reasonable construction. *Fiess* at *21.[8]

The debate between the majority and dissenting opinions went on, but the detail is somewhat beyond the scope of this brief write-up.[9]

Lastly, the *Fiess* court stated that its decision was consistent with most other jurisdictions. In so saying, the court noted that ensuing loss clauses are "common in all-risk policies, and while rarely identical they share more similarities than differences." *Fiess* at *22. In support, the court went on to cite approximately 25 decisions from around the country, with many having nothing to do with mold and containing different language than in the Texas HO-B form. E.g., *Ames Privilege Assoc. Ltd. Partnership v Utica Mut. Ins. Co.*, 742 F. Supp. 704, 708 (D. Mass. 1990) ("These are perils which are excluded by the policy [Loss caused by wet or dry rot, deterioration, settling and cracking of walls, floors, roofs or ceilings]. They cannot be, at the same time, perils which are not excluded, and for which the defendant would be liable for any ensuing loss."); *Weeks v Co-Operative Ins. Cos.*, 817 A.2d 292, 296 (N.H. 2003) ("[T]he exception to the exclusion operates to restore coverage if the damage ensues from a covered cause of loss. 'Reasonably interpreted, the ensuing loss clause says that if one of the specified uncovered events takes place, any ensuing loss which is otherwise covered by the policy will remain covered. The uncovered event itself, however, is never covered.'") (citation omitted).

While *Fiess* may have adopted a majority view, the decision demonstrates that the "ensuing loss" issue is not without much debate and arises under myriad circumstances. Therein lies the significance of *Fiess*—given its thoroughness, it has the potential to influence future "ensuing loss" cases in states other than Texas and involving losses other than mold. ■

Endnotes

1. There also seemed to be more state high court decisions than usual in 2006 addressing very fact-specific coverage situations. These decisions may be important or interesting in their own right, but are less likely to be influential on courts in the years ahead.
2. One final note on the selection process: Two insurance blogs that I read to monitor coverage developments are valuable resources and worthy of your time (I promise). In last year's Top 10 Coverage Cases of the Year article I plugged Marc Mayerson's blog—Insurancescrawl.com. I once again direct your attention to this excellent blog that provides law review-like analysis of major coverage decisions. This year I must also give a shout-out to David Rossmiller's blog at www.insurancecoverageblog.com. See for yourself the superb job that this reporter-turned-lawyer does of providing daily news and commentary from the coverage world. If after a week you start saying to yourself—How does he do this every day?—you will not be alone.
3. The issue of how to distinguish between covered and uncovered damages in a settlement was the subject of some discussion last year in *Perdue Farms v Travelers Casualty & Surety Company*, 448 F.3d 252 (4th Cir. 2006). Further, the principal decision in Perdue Farms was itself important and the case was considered for inclusion as one of the year's 10 most significant coverage decisions. The Fourth Circuit held that an insurer was not entitled to reimbursement of defense costs for non-covered claims: "Under Maryland's comprehensive duty to defend, if an insurance policy potentially covers any claim in an underlying complaint, the insurer, as Travelers did here, must typically defend the entire suit, including non-covered claims. Properly considered, a partial right of reimbursement would thus serve only as a backdoor narrowing of the duty to defend, and would appreciably erode Maryland's long-held view that the duty to defend is broader than the duty to indemnify." *Perdue Farms* at 258 (citation omitted). Thus, the *Perdue Farm* court was "unwilling to grant insurers a substantial rebate on their duty to defend." Id.
4. A press release from Anderson, Kill & Olick announcing the Texas Supreme Court's decision to grant rehearing in *Frank's Casing* noted that the decision had been named one of the 10 most significant coverage decisions of 2005 by *Mealey's Insurance*. Thanks for the plug, guys. Anderson, Kill submitted an amicus brief on behalf of United Policyholders in support of Frank's Casing's position. See "Texas Supreme Court Grants Rehearing on its Decision in Frank's Casing," posted at http://www.insurancebroadcasting.com/011806-6.htm.
5. The specific policy provision at issue was an exclusion that provided, "We do not provide Liability Coverage for any 'insured' . . . [u]sing a vehicle without a reasonable belief that that 'insured' is entitled to do so." *Patrons Oxford* at 823.
6. The *Patrons Oxford* court's conclusion that an insurer who reserves the right to deny coverage cannot control the defense of a lawsuit brought against its insured by an injured party was in the context of an insured's ability to settle a case without the insurer's consent. It will likely be an easy leap for policyholders to assert that the court's decision also means that an insurer who reserves the right to deny coverage cannot select defense counsel. On this issue, see *Twin City Fire Insurance Company v Ben Arnold-Sunbelt Bev Co. of South Carolina,* 433 F.3d 365 (4th Cir. 2005), in which the Fourth Circuit (South Carolina law) addressed this argument in detail in a December 27, 2005 opinion—handed down too late for consideration in last year's edition of The Year's Ten Most Significant Insurance Coverage Decisions. The *Ben Arnold* court rejected the notion that a reservation of rights letter creates a per se conflict of interest that must be remedied through the insured selecting counsel at the insurer's expense.

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7. I mean no disrespect to the Vermont Supreme Court. I'm just going by the numbers. A Lexis search undertaken at the time of this writing of Vermont state and federal courts for "mold w/20 insurance or policy" returned four hits, with three coming from the Second Circuit and involving non-Vermont appeals and only one having something to do with mold (but not insurance). Compare that to the same search for Texas state and federal courts, which returned 111 hits. Now, when the search term is "ski lift" . . . .
8. Then, revealing that Justice Hecht isn't the only witty member of the Texas Supreme Court, Justice Brister added, "It is true that some combinations are unlikely, such as wear-and-tear followed by glass breakage that causes mice. But with 1,452 to choose from, no doubt plenty of options remain." *Id.*, n.31.
9. For a look at how the decision may affect future mold claims in Texas, written by a Texas policyholder attorney, see John F. Melton, "*Fiess v State Farm Lloyds*—Mold Coverage—Texas Supreme Court says Texas Insurers, Homeowners, and Texas Department of Insurance Misread Policy," *Policyholder Advocate*, October 2006, Published by Policyholders of America.

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