Your Coverage Advisor

# Why Federal Judges are Dismissing Coverage Claims

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It is a well-known "secret" among insurance coverage firms that policyholders are often better served in state court, rather than federal court. To avoid giving the policyholder any conceivable advantage of appearing in a state forum, insurers will sometimes race to the courthouse and file a declaratory judgment action in federal court under 28 U.S.C. § 2201 (the "Declaratory Judgment Act").

> "More and more federal courts are declining to exercise jurisdiction over declaratory judgement actions that involve coverage matters."

While this once was a standard and accepted practice, it has come under some scrutiny as some federal judges are exercising their right to dismiss insurance coverage matters that are brought before them.

One of the first notable cases in which this occurred was *State Auto Ins. Co. v. Summy.* In this Pennsylvania case, the lower court granted the insurer's

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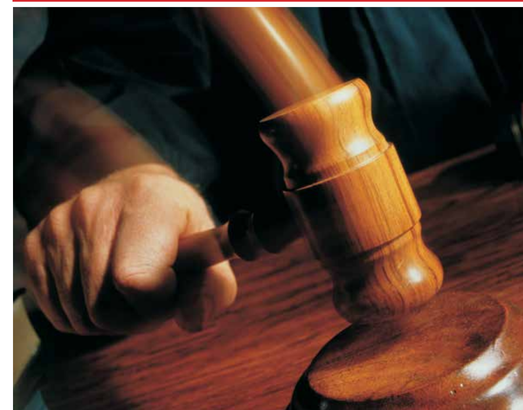

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# Why Federal Judges are Dismissing Coverage Claims

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motion for summary judgment and held that the policy's pollution exclusion barred coverage. The insured appealed and argued, in part, that the lower court had improperly assumed jurisdiction under the Declaratory Judgment Act where there was a pending state court lawsuit covering the same issues, even though the state court action had been filed after the insurer filed suit in federal court. The appellate court agreed with the insured and found that the state court was the better forum given that the interpretation of pollution exclusion clauses was an unsettled matter of state law and there were no federal issues or interests at play.

The Summy court discussed the analysis that should apply in determining whether to hear a declaratory judgment case concerning insurance coverage: (1) adhere to a general policy of restraint when the same issues are pending in a state court; (2) consider whether there is an inherent conflict of interest raised when an insurer has a duty to defend in state court while attempting to characterize a suit in federal court as falling within the scope of a policy exclusion; and (3) avoid duplicative litigation. The Summy court likewise noted that federal courts are to apply state law (or predict it where unsettled), but not establish state law. According to the court, "it is counterproductive for a district court to entertain jurisdiction over a declaratory judgment action that implicates unsettled questions of state law... [when such matters] should proceed in normal fashion through the state court system."

Since *Summy,* more and more federal courts are declining to exercise jurisdiction over declaratory judgment actions that involve coverage matters. For instance, in *Cont'l Ins. Co. v. Hexcel Corp,* the insurer filed a declaratory judgment action in the United States District Court for the Northern District of California and sought a ruling that it was under no obligation to defend or indemnify the insured for environmental contamination at its former plant. Shortly thereafter, the insured filed an action for breach of contract against Continental in New Jersey state court and moved to dismiss the insurer's federal court action. The court agreed with the insured and dismissed the federal court case in favor of the later-filed state court case.

In deciding whether to abstain in favor of the state court action, the *Hexcel* court considered the same factors that the Summy court considered, but also considered whether abstaining would discourage forum shopping and prevent the district court from needless determination of state law issues. As well, the court looked at the following: (1) whether the federal court action would settle the entire controversy;

(2) whether it would serve a useful purpose at clarifying the legal relations at issue; (3) whether declaratory relief was being sought merely as an attempt at procedural fencing and to obtain an unfair advantage; (4) whether the use of declaratory relief would result in entanglement between the federal and state court systems; (5) the convenience of the parties; and (6) the availability and relative convenience of other remedies.

In North Carolina, a similar result was reached in *Essex Ins. Co. v. Champion Charters, Inc.* In that case, the insurer filed a declaratory judgment action in federal court seeking a declaration that it was not required to indemnify the policyholder for alleged negligence stemming from an explosion on a charter boat. The *Champion Charters* court dismissed the action without prejudice so that the insurer could seek a declaration in state court. Because the state law was unsettled, the *Champion Charters* court felt that the issues were better decided by the state court. Likewise, in *Nat'l Cas. Co. v. Hertz Equip. Rental Corp.,* a federal court in New Jersey declined to exercise jurisdiction over an insurer's declaratory judgment action, reasoning that an insurer's previously filed action dealt with the same issues, none of which involved federal law.

Such cases are becoming more common, as federal courts around the country are holding that they can and should abstain from ruling on coverage actions that do not present federal issues, or otherwise implicate any of the previously noted factors in such a way as to support litigation in federal court. This is a positive trend for policyholders and one that will hopefully continue. ■

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# Choosing The Battlefield

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When a claim is disputed, a policyholder's best course typically is to negotiate. However, when persuasion is ineffective and a claim must be litigated, the place where it is litigated—otherwise known as the forum—often will determine the claim's outcome.

Because the battlefield can be critical, a policyholder should keep in mind certain factors bearing on the choice and the right to make it.

First, it is important to recognize that parties to coverage disputes often will have a number of options when they are choosing where to file suit. In regard to a liability claim, for instance, the policyholder may be in one state, the insurer or insurers in other states, and the underlying claimants in still other states. In addition, the policy may have been negotiated in one or more states, may have been issued in one state and sent to another, and may have been placed through a broker in yet another. All of these locations may be potential forums.

Further, the substantive law of the chosen forum will not necessarily apply to the claim. The choice-of-law rules of the forum, however, will determine how that substantive law gets chosen. Typically, there are two steps to determining which law will be applied in each potential forum.

The complexity of forum selection may be exceeded only by its importance. Coverage law varies, sometimes widely, from jurisdiction to jurisdiction. A claim that has great merit in one jurisdiction may have no merit in another. Hence, although forum selection may seem to be merely an arcane procedural exercise, it is much, much more.

Because forum is so important, insurers frequently attempt to seize control of the selection process by filing declaratory judgment suits in their preferred forums. A forum chosen by an eager insurer will not necessarily be the one to decide a claim, but it typically will be. Accordingly policyholders involved in claim disputes are well served to keep the following in mind:

- When it appears a claim will have to be litigated, the policyholder should evaluate the law that would be applied in each potential jurisdiction and compare the claim's relative prospects under all such laws.
- If multiple jurisdictions offer similarly favorable prospects, matters of convenience and expense, such as proximity to witnesses and records, may determine the best choice of jurisdiction.
- Certain factors that may affect timing, such as the relative size of the various courts' dockets and the relative effectiveness of the courts in managing cases, may also influence choice of jurisdiction.

Perhaps most importantly, policyholders should keep in mind that insurers are highly sensitized to these forum factors. An insurer that believes a coverage suit is inevitable and imminent may file suit in the court of its choice, to enhance its prospects of succeeding or at least to limit its costs and inconvenience while increasing these factors for the policyholder. Policyholders, therefore, should evaluate their forum prospects early, and should be vigilant to avoid getting "beaten to the courthouse." A policyholder can lose a case by waiting too long to sue—perhaps delaying to schedule one more meeting or to write one more letter—thereby ceding the forum initiative, and possibly the case outcome, to the insurer. ■

# Determining Whether Claims for Water Damage are Covered by Property Insurance Policies

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Rain, rain, go away…. Many property owners were uttering this popular refrain last winter when they experienced damage from rain, snow, floods, and other water-related events. Property insurance policyholders were scrambling to limit the amount of water damage while trying to convince their insurance carriers to honor their coverage obligations. Many policyholders learned however, that their carriers might not honor claims because of provisions in their policies excluding coverage for losses that result from floods, surface water, or water from backup or overflow of a sewer, drain, sump or other bodies of water.

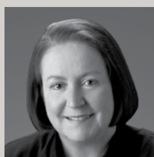
Policyholders are entitled to coverage for claims that arise from physical damage that occurs during the policy period. However, many policies exclude water damage that results from flooding or an overflowing sewer or drain. Depending on their language, certain policies will not provide coverage for damage that is caused even *in part* by flooding, surface water or an overflowing sewer, even if a covered act also played a role in causing the damage. The precise scope of these provisions, called "anti-concurrent causation" provisions, varies among policies, so policyholders should carefully review the specific language contained in their policy.

In addition, very few policies define "flood" or "surface water," so policyholders are unsure about the type of claims that are covered and courts are left to interpret the meaning of the policy terms. Though courts generally should construe exclusionary language strictly, in favor of the policyholder, they have not always done so in the context of water damage cases. For example, one appellate court recently found that storm water that overflowed onto the driveway and through a property's front doors constituted "surface water" that was not covered under the policy. The court came to this conclusion despite the fact that the term "surface water" was undefined in the policy and could have multiple meanings, some of which would result in coverage under the policy.

Similarly, a state Supreme Court held that the overflow of a river basin from heavy rainfall constituted a flood and the policyholders were not

entitled to coverage for the property damage. In that case, several policyholders sued their insurance companies for water damage caused by failed dikes. In determining whether a flood occurred, the court considered the dictionary definition of flood and held that the policies excluded coverage for the claim, even if there were other circumstances that affected the flooding. The court found that the policy exclusion applied despite the fact that branches and other debris had caused the waterways to become clogged and create the overflow of water.

In many cases, the likelihood of enforcing coverage for water damage claims depends on how the damage was caused and whether the policy contains exclusions for flooding or surface water. As winter approaches and increased amounts of precipitation can be expected, now is a good time for policyholders to review their policies and become familiar with the terms relating to coverage for water damage. ■



# Decision Points

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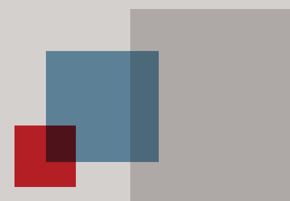

Legal decisions interpreting insurance policies provide guidance on the meaning of various provisions and whether or not a particular happening may or may not be covered. A few recent legal decision points of note follow:

## CINCINNATI INSURANCE COMPANIES V. MOTORISTS MUTUAL INSURANCE COMPANY

2014-Ohio-3864 (9th Dist. September 8, 2014): This dispute was between insurers who issued CGL coverage to an electrical subcontractor that provided services in connection with the construction of a home. A fire in 2006 substantially destroyed the residence and most of the belongings. Nationwide, which provided homeowner's insurance at the time of the fire, settled the claim for over $850,000. Nationwide subsequently sued a number of entities, including the subcontractor and two of its CGL insurers (Cincinnati and Motorists) to recover the settlement amount.

Both Cincinnati and Motorists initially refused to defend or indemnify their insured because the fire happened after their respective policy periods. Based on an intervening decision, *Ohio Cas. Ins. Co. v. Hanna,* Cincinnati reconsidered its position and provided a defense to its insured. Motorists continued to refuse to either defend or indemnify the subcontractor.

Cincinnati settled with Nationwide and sued Motorists for contribution. The trial court granted summary judgment to Motorists because the property damage occurred during the fire after the expiration of the Motorists' policy period. The trial court inappropriately confined its analysis to the issue of liability and did not consider whether the allegations in the complaint excluded the possibility of property damage during the Motorists' policy period.

The *Hanna* case adopted a continuous trigger which requires a policy to respond where collateral damage occurring outside of the policy period, such as the fire, resulted from "initial and consequential"

damage occurring during the policy period. Although the fire occurred after the CGL policy periods, the fire was alleged to be the result of consequential risks that stemmed from the contractors' work. Although "policies do not insure an insured's work itself", CGL "policies generally insure consequential risks that stem from the insured's work." Thus, the complaint asserted claims that arguably or potentially were within policy coverage, triggering a duty to defend. Accordingly, the Court of Appeals reversed summary judgment in favor of Motorists.

## GERKEN V. STATE AUTO INSURANCE CO

2014-Ohio-4428 (4th Dist. September 8, 2014): A fire occurred at the policyholder's vacation home causing damage to both real and personal property. Motions for summary judgment were granted for the insurer in a subsequent lawsuit for breach of contract and bad faith. As to the bad faith claim, the Court of Appeals reaffirmed that Ohio recognizes that an insurer has a duty to act in good faith in the payment and handling of claims and that duty is independent of a breach of contract claim. Rather than subjective intent, Ohio uses a "reasonable justification" standard in assessing whether an insurer has acted in bad faith. An insurer lacks reasonable justification for its claims handling or denial when its actions are arbitrary or capricious. Ambiguity in the policy language is insufficient to prove bad faith and a bad faith claim will be denied if an insurer's interpretation of an ambiguous policy provision is reasonable.

## VEACH V. CHUCHANIS

2014-Ohio-2949 (5th Dist. June 30, 2014). Sentry Life Insurance Company issued a policy to an insured, Tracy, in 1991. Tracy listed a primary beneficiary (Chuchanis) and a contingent beneficiary (Veach). On two separate occasions in ensuing years, Tracy sent letters to Sentry advising it that her name had changed and that she wanted to change beneficiaries. On at least one of those occasions, Tracy identified the purported new beneficiary by name in her correspondence. On both occasions, Sentry sent change of beneficiary forms to Tracy at the address to which she received premium invoices advising her that, under the terms of the policy, the forms needed to be completed and returned to accomplish the change. Tracy did not complete and return the change of beneficiary form on either occasion. After the second notice to Sentry about a potential change of beneficiary, Tracy reportedly told a friend that she still loved Chuchanis and intended for him to receive the life insurance proceeds in the event of her death. Subsequently, Tracy died and both Chuchanis and Veach claimed proceeds of the policy. Sentry interpled the life insurance proceeds with the court. The Court of Appeals followed the Ohio Supreme Court's recent decision in *LeBanc v. Wells Fargo Advisors, L.L.C.* The *LeBanc* court adopted and reaffirmed a longstanding principle from life insurance cases that an insurance company waives compliance with the insurance policy's requirements when it files an interpleader action. In such circumstances "proof of substantial compliance with … procedures for changing the beneficiary is not required." and the only factor to be considered in determining a beneficiary is the "clear intent of the decedent." Though not at issue in the case, had the life insurance proceeds not been interpled, a different result would have likely occurred. Thus, the safer course is to advise clients to read and follow policy requirements and complete and return all requisite forms to the insurance company to ensure that the insured's beneficiary wishes will in fact be followed. ■

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# Attorney Highlights

The firm received the 2015 Best Law Firms Tier 1 Ranking for Insurance Law in Akron.

Christopher J. Carney, Clair E. Dickinson and Paul A. Rose were named to the Best Lawyers in America 2015.

Amanda M. Leffler, Lucas M. Blower, Keven D. Eiber and Paul A. Rose spoke at the 2014 Brouse McDowell Annual Insurance Coverage Conference on October 2, 2014 at The Embassy Suites in Independence, Ohio.

Keven Eiber is program chair of, and a speaker at, the FBA/CMBA's advanced insurance law seminar "A Funny Thing Happened on the Way to the Forum: Issues of State and Federal Jurisdiction in the Context of Complex Insurance Coverage Litigation" on November 19, 2014.

Keven Eiber will be a panelist as part of a presentation entitled "Detour Ahead: Federal Court Certification of Questions of Insurance Coverage Law to State Supreme Courts," at the American Bar Association's 2015 Insurance Coverage Litigation Committee CLE Seminar in Tucson, Arizona.

Amanda M. Leffler spoke at the Akron Bar Association's Annual Insurance Coverage Seminar regarding Insurance Coverage for Emerging Energy Risks, on October 30, 2014.

Gabrielle T. Kelly was a speaker at SPACES, an event by the CMBA Volunteer Lawyers of the Arts group.