Your Coverage Advisor

Insurance Coverage Newsletter
Summer 2017 (Vol. XVI)

It's Tradition! Pollution Exclusion Applies Only to Traditional Environmental Contamination: New Cases from Washington and Connecticut

By Lucas M. Blower
lblower@brouse.com

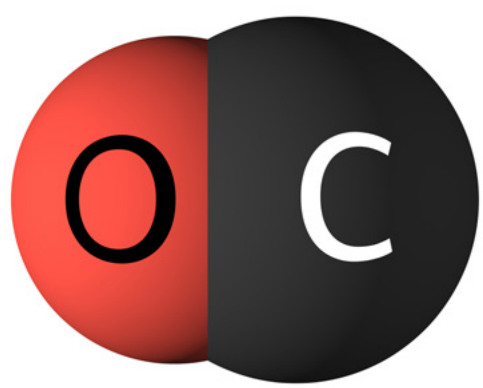
In general, a pollution exclusion precludes coverage for liabilities arising from the "discharge, dispersal, release or escape" of "irritants, contaminants or pollutants." The exclusion was incorporated in commercial general liability (CGL) insurance policies in response to the massive environmental liabilities incurred by companies in the 70's and 80's.

And the exclusion has been effective, by in large, in precluding coverage for liabilities that are the result of traditional environmental contamination. But, for some insurers, that was not enough. These insurers argued that the pollution exclusion leaches out in new directions, applying not only to traditional environmental contamination, but extending to apply in new, non-pollution contexts as well.

For example, in *Andersen v. Highland House Co.*, 93 Ohio St. 3d 547, 757 N.E.2d 329 (2001), the insurers relied on the pollution exclusion to deny a claim based on carbon monoxide poisoning in an apartment—hardly the sort of widespread environmental damage first envisioned by the pollution exclusion. The insurer nonetheless argued that the pollution exclusion applied because carbon monoxide was a "pollutant," which the policy defined as "any solid, liquid, gaseous or thermal irritant or contaminant,

(Continued on page 2)

IN THIS ISSUE



BROUSE McDowell®
A Legal Professional Association

including smoke vapor, soot, fumes, acids, alkalis, chemicals and waste." *Id.* at 548. The Ohio Supreme Court, however, disagreed, holding that the pollution exclusion would not apply because it did not "specifically, and unambiguously state that coverage for residential carbon monoxide poisoning is excluded." *Id.* at 548. According to the Court, the pollution exclusion was limited to situations involving "traditional environmental contamination." *Id.* at 552.

While insurers have been rebuffed in their efforts to expand the scope of the pollution exclusion in Ohio, in other states, they continue to push at the edges of the pollution exclusion, hoping to spread its reach past the confines of traditional environmental contamination. But, in two recent cases—from Washington and Connecticut—the courts rightly halted the insurer's attempts to expand the exclusion.

The recent decision from Washington's Supreme Court, in *Zhaoyun Xia v. ProBuilders Specialty Ins. Co. RRG*, 393 P.3d 748, 750 (Wash. 2017), mirrors *Andersen* in the facts, and reaches the same conclusion, but by a slightly different route. The underlying claim in *Xia* was based on the "negligent installation of a hot water heater that led to the release of toxic levels of carbon monoxide in a residential home." The insurer denied the claim based on the pollution exclusion.

In interpreting the pollution exclusion, the *Xia* court, similar to the *Andersen* court, recognized that the pollution exclusion should only apply when the underlying cause of alleged liability "stems from either a traditional environmental harm or a pollutant acting as a pollutant." *Id.* at 753. Unlike the *Andersen* court, however, the *Xia* court found that the carbon monoxide poisoning could be characterized as pollution. Still, the *Xia* court found that the insurer's interpretation of the pollution exclusion violated Washington's efficient proximate cause rule. Under that rule, a loss is covered, even if there are uncovered events within the causal chain leading to that loss, so long as the initial event—or the "efficient proximate cause"—is a covered peril. In *Xia*, the court found that the efficient proximate cause of the loss was the negligent installation of the hot water heater, which was covered. Accordingly, the pollution exclusion did not apply.

In Connecticut, likewise, an appellate court addressed a case where the insurer was arguing for an expansive version of the pollution exclusion. In *R.T. Vanderbilt Co., Inc. v. Hartford Accident & Indem. Co.*, 156 A.3d 539 (Conn. App. 2017), the policyholder was accused of mining and selling industrial talc that contained asbestos, which allegedly injured a host of claimants. The policyholder submitted a claim based on the lawsuits to its insurers, which denied the claims, in part, based on the pollution exclusion. The Connecticut appellate court disagreed with the insurers' interpretation of the exclusion after an exacting review of the policy language. According to the court, the "policy language, when read as a whole, is intended to exclude coverage only for traditional environmental pollution, such as the intentional disposal or negligent release of industrial and other hazardous waste into the public air, land, or water resources." *Id.* at 638. Since talc mining didn't count as traditional environmental pollution, the court held that the pollution exclusion did not apply.

These two cases, and many others like them, should give insurers pause when they argue for a broad application of the pollution exclusion in non-traditional settings. Even if the terms in the pollution exclusion, standing alone, may seem broad enough to encompass ever new risks, the courts have rightly decided that they will *not* read the terms of the pollution exclusion standing alone. Rather, courts will continue their long-standing practice of interpreting the pollution exclusion solely within the limited context in which it was written. It's tradition. ■

Coverage for Construction Defects Caused by Subcontractor Work

By Amanda M. Leffler
aleffler@brouse.com

The Ohio Supreme Court has held that claims for the cost to repair an insured's own defective work are not covered because they "are not claims for 'property damage' caused by an 'occurrence' under a [CGL] policy." *See Westfield Ins. Co. v. Custom Agri Sys., Inc.*, 2012-Ohio-4712. In its decision, however, the Court approved of prior Ohio case law which held that consequential damages *arising from* a policyholder's defective work generally *are* covered by CGL policies. Since *Custom Agri,* insurance practitioners and courts in Ohio have generally agreed that:

- **Repair and replacement of a policyholder's own defective work is not "property damage caused by an occurrence" and is not covered by standard CGL policies; and,**
- **Consequential damages to property other than the policyholder's work is "property damage caused by an occurrence" and may be covered by a standard CGL policy depending upon the applicability of the policy's exclusions and conditions.**

Importantly, the *Custom Agri* Court did not address whether a typical CGL policy would provide coverage for the repair or replacement of defective work performed by the policyholder's *subcontractors*. A recent decision from one of Ohio's appellate courts suggests that defective work performed by a policyholder's subcontractors may be covered, regardless of whether the subcontractor's work caused any consequential damages.

In 2008, Ohio Northern University contracted with Charles Construction Services (CCS) to construct a hotel and conference center. *Ohio Northern Univ. v. Charles Constr. Servs., Inc.*, 2017-Ohio-258 (3rd Dist.). CCS retained several subcontractors to complete the work. After construction was completed, Ohio Northern discovered significant water intrusion and related damages, as well as serious structural defects, and brought suit against CCS.

CCS tendered the claim to its insurer, Cincinnati Insurance Company, which argued that it had no obligation to defend or indemnify CCS. Cincinnati contended that, under *Custom Agri*, property damages arising from defective work could *never* constitute an occurrence, regardless of who performed the work. In response, CCS argued that *Custom Agri* was inapplicable because almost all of the work at issue had been performed by subcontractors, *not* by CCS, and because CCS had purchased products-completed operations coverage which applied to the defective construction claims arising from the work of its subcontractors.

The trial court granted summary judgment to Cincinnati, but the Third District Court of Appeals reversed. In finding in favor of CCS, the appellate court analyzed the "Damage to Your Property" and "Damage to Your Work" exclusions, which expressly preserved coverage for damaged work or damages arising from faulty work if (1) the work was performed by a subcontractor, and (2) the damage occurred after construction was completed. The appellate court correctly noted that if it were to adopt Cincinnati's interpretation of the policy, it would render these provisions meaningless. The court found that, at a minimum, the provisions created an ambiguity that must be resolved in favor of the policyholder. Thus, the appellate court held that Cincinnati had a duty to defend and indemnify CCS.

Interestingly, though not analyzed by the appellate court, even if the work at issue had been performed by CCS and not its subcontractors, the damages alleged by Ohio Northern would have required that Cincinnati defend CCS and indemnify at least a portion of any award against it. This is because Ohio Northern asserted claims not only for the repair and replacement of defective work, but also for consequential damages arising from such work. As noted above, the Supreme Court in *Custom Agri* cited with approval prior lower court opinions, which held that CGL policies cover such claims for consequential damages.

Insurers and policyholders in Ohio continue to test the scope of the Ohio Supreme Court's decision in *Custom Agri*. As in any case involving complex coverage analysis, policyholders should consider retaining experienced coverage counsel to assist in the claim process so as to best position their claim for coverage. ■

D & UH-OH: Deepening Insolvency May Be a Prior Wrongful Act, Barring Claims for Post-Policy Fraudulent Transfers

By Bridget A. Franklin
bfranklin@brouse.com

Some "D&O policies" (Directors and Officers liability policies) exclude claims for losses "arising out of" the prior wrongful acts of officers or directors. The Eleventh Circuit recently interpreted the phrase "arising out of" broadly, finding that it is not a difficult standard to meet. *Zucker for BankUnited Financial Corp. v. U.S. Specialty Insurance Co.*, -- F.3d -- , 2017 WL 2115414, *7 (2017) (determining that under Florida law "'arising out of' . . . has a broad meaning even when used in a policy exclusion"); *but see Brown v. American Intern. Group, Inc.*, 339 F. Supp. 336, 346 (D. Mass. 2004) (collecting cases in support of its holding that "arising out of" should be "more strictly interpreted when used to define exclusions from coverage."). In *Zucker,* the Chapter 11 bankruptcy trustee filed an action against the debtor bank's D&O insurer for its failure to pay claims related to fraudulent transfers that occurred during the policy period.

By way of background, in 2008, after some investigation and the collapse of the financial market, BankUnited Financial Corporation ("BankUnited") and its subsidiary BankUnited, FSB (the "Subsidiary") admitted to engaging in "unsafe and unsound practices," including risky subprime lending. Unsurprisingly, these practices rendered both banks insolvent. Notwithstanding these admissions, in November 10, 2008, BankUnited obtained a D&O Policy with a Prior Acts Exclusion, opting to forego the higher premium policy without the exclusion.

In early 2009, while still insolvent, BankUnited's officers approved $46 million in transfers to the Subsidiary bank ("Transfers"). In May of 2009, the Subsidiary was seized by the FDIC and BankUnited filed for Chapter 11 bankruptcy protection. The bankruptcy trustee sued the officers for, among other things, breach of fiduciary duties for authorizing the Transfers. The trustee alleged that the Transfers were in violation of Florida's Uniform Fraudulent Transfers Act ("UFTA") in part because they were made while BankUnited was insolvent. The claims were tendered to and denied by the D&O insurer. The officers and trustee entered into a settlement agreement, assigning the officers' insurance claims to the trustee.

In Zucker, the trustee alleged that the insurer was liable under the D&O policy because the Transfers, or wrongful acts, were made after the policy date. The court disagreed. Interpreting "arising out of" broadly, the court determined that the officers committed multiple wrongful acts prior to the policy date that rendered BankUnited insolvent. Although the Transfers occurred during the policy period, the court held that Transfers were only fraudulent under the UFTA because BankUnited was insolvent at the time, and the insolvency was a result of the prior wrongful acts of the officers.

The court was particularly bothered by BankUnited's "economical" decision to forego a policy without the Prior Acts Exclusion while aware of its insolvency. Although not all courts will interpret "arising out of" as broadly as the Eleventh Circuit, as a precaution, when a company is insolvent or is on the verge of insolvency, the company should, in the very least, pay the higher premium to obtain stronger protection for the acts of its officers and directors. ■

He Madoff With All My Money: Is there Insurance Coverage for Ponzi Schemes?

By Anastasia J. Wade
awade@brouse.com

In late May, 2017, HBO released the movie The Wizard of Lies, chronicling the discovery of the Bernard L. Madoff Ponzi Scheme. Literally robbing Peter to pay Paul, Madoff ran his fraud scheme for decades, amassing almost $65 billion in investments before he was caught in December, 2008. As a result of his arrest and the discovery of the fraud, individual investors, hedge funds, charities, and businesses discovered that their money was gone. Unable to reclaim their investments from Madoff or his insolvent companies, many turned on their investment firms and banks to recover at least some of their losses. In turn, these institutions scoured their insurance policies looking for any avenue of potential coverage for both their defense in the lawsuits and any resulting monetary award.

While there may be other sources of coverage available, many of the insurance cases resulting from Ponzi schemes focus on these three areas of coverage: Directors and Officers Liability Policies, Errors and Omissions/ Professional Liability Policies, and Fidelity Bonds.

Directors and Officers Liability Policies

Directors and Officers Liability Policies ("D&O policies") are designed to protect corporations and directors and officers from liability for decisions made on behalf of the corporation. If the policy is triggered and provides coverage, however, D&O policies often have combined limits for defense costs and indemnification costs, meaning that as litigation against the director or officer drags on, the costs of defense decrease the total amount available for recovery once a final judgment is issued. Moreover, common policy exclusions can

(Continued on page 6)

prevent an investor's ultimate recovery. If the policy excludes coverage for fraud and/or money laundering, the insurer will likely be required to provide defense costs to the director or officer until there is a final judgment, but will not be required to provide indemnification in the event the court concludes that the director or officer is liable for fraud or money laundering. *See Pendergest-Holt v. Certain Underwriters at Lloyd's of London,* 600 F.3d 562 (5th Cir. 2010). More recent exclusions prevent any coverage for Ponzi schemes, including for losses arising out of a company's insolvency, which is how Ponzi schemes are often discovered, or losses attributable to the rendering of professional services, in which directors or officers are often engaged when recommending investment in a Ponzi scheme. *See Associated Community Bancorp, Inc. v. The Travelers Cos., Inc.,* Case No. 3:09-CV-1357, 2010 WL 1416842 (D. Conn. April 8, 2010).

Errors and Omissions/ Professional Liability Policies

Errors and Omissions liability policies ("E&O policies") and professional liability policies provide coverage for losses arising out of the provision of professional services. Like D&O policies, coverage of losses from a Ponzi scheme under these policies will often turn on the applicability of an exclusion; and one popular exclusion among these policies is for claims resulting from violations of state or federal securities laws. Whether there is coverage for the underlying lawsuits resulting from a Ponzi scheme depends on whether there is a separate, stand-alone negligence action, apart from a securities violation claim, that can trigger coverage under the policy. *Compare Endurance Am. Specialty Ins. Co. v. Brown, Miclette & Britt, Inc.,* Case No. H-09-2307, 2010 WL 55988 (S.D. Tex. Jan. 4, 2010) *with Hiscox Dedicated Corporate Member Ltd. v. Partners Commercial Realty, L.P.,* Case No. H-08-3411, 2009 WL 1794997 (S.D. Tex. June 23, 2009). Additionally, for employees acting without company approval, some E&O and professional liability policies preclude coverage for losses resulting from "unapproved" sales, meaning that there would be no potential coverage if the company did not approve of the investment in the Ponzi scheme and the employee continued with the transaction. *See Smith v. Continental Cas. Co.,* 347 Fed. Appx. 812, 2009 WL 3214234 (3d Cir. Oct. 8, 2009).

Whether there is coverage for the underlying lawsuits resulting from a Ponzi scheme depends on whether there is a separate, stand-alone negligence action, apart from a securities violation claim, that can trigger coverage under the policy.

Fidelity Bonds

The primary purpose of a fidelity bond is to protect a company from an employee's dishonest conduct. *See Fidelity National Financial, Inc. v. National Union Fire Ins. Co. of Pittsburgh, PA,* 2014 WL 4909103 (S.D. Cal. Sept. 30, 2014). Sometimes, this protection can also extend to the company's outside agents such as Madoff, who ran his own, separate company and acted alone in his dishonest acts. In *Jacobson Family Investments, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA,* 129 A.D.3d 556 (N.Y. 1st. Dep. 2015), the remaining plaintiff, MDG 1994 Grat, LLC ("MDG") sought to recover for losses arising from the investment of MDG's assets with Madoff. The fidelity bond provided coverage for "loss resulting directly from the dishonest acts of any Outside Investment Advisor, named in the schedule below, solely for their duties as an Outside Investment Advisor." Madoff was listed as an Outside Investment Advisor in the schedule for the bond and the loss was a result of Madoff's dishonest acts. As a result, the lower court found that the bond provided coverage for the loss.

The appellate court, however, reversed the trial court's decision based on the requirement that the loss must result "solely" from Madoff's duties as an Outside Investment Advisor. Because Madoff also served as a securities broker at the same time he was an investment advisor, the appellate court reasoned that the loss suffered by MDG was not solely a result of Madoff's duties as an Outside Investment Advisor and, thus, did not fall under the coverage of the bond. The court also noted that an exclusion for losses resulting from dishonest acts of a non-Employee securities broker would also prevent coverage in this case. *See also United States Fire Ins. Co. v. Nine thirty FEF Investments, LLC,* 132 A.D.3d 413 (N.Y. 1st Dep. 2015).

Investing in the market is always a risk. As such, there are very few sources of insurance coverage for any resulting losses. When someone improperly manipulates the system through a fraudulent scheme, however, there may be some coverage available. The possibility and extent of such coverage will depend on the particular policy language implicated by the claim. In the case of lawsuits resulting from Ponzi schemes, coverage will often depend on who is named in the lawsuit, what role he played in the scheme and the nature of the allegations against him. In any case, investors in Ponzi schemes will likely face a long road to recovery. ■

Office Locations

Akron
388 South Main Street, Suite 500
Akron, OH 44311-4407
Phone: 330.535.5711

Cleveland
600 Superior Avenue East, Suite 1600
Cleveland, OH 44114-2604
Phone: 216.830.6830

Youngstown
6550 Seville Drive, Suite B
Canfield, Ohio 44406-9138
Phone: 330.533.6195

Lorain County
5321 Meadow Lane Court, Suite 7
Sheffield Village, OH 44035-0601
Phone: 440.934.8080

Insurance Recovery Attorneys
Lucas M. Blower
Kate M. Bradley
Nicholas P. Capotosto
Christopher J. Carney
Alexandra V. Dattilo
Clair E. Dickinson
Bridget A. Franklin
JoZeff W. Gebolys
Kerri L. Keller
Gabrielle T. Kelly
P. Wesley Lambert
Amanda M. Leffler
Sallie Conley Lux
Caroline L. Marks
Meagan L. Moore
Amanda P. Parker
Paul A. Rose
David Sporar
Christopher T. Teodosio
Anastasia J. Wade

Attorney Highlights

Kerri L. Keller was appointed to the City of Hudson Income Tax Board of Review

Gabrielle T. Kelly spoke at the CMBA Insurance Law Seminar on June 9, 2017 on The Law's Response to Phishing and Social Engineering Schemes

Wes Lambert graduated from the Leadership Hudson Class of 2017

Wes Lambert and **JoZeff Gebolys** published an article for the American Bar Association titled "Coverage for Construction Defect Claims May Hinge on a Clearly Defined Scope of Work" (June 27, 2017)

Wes Lambert published an article for the American Bar Association titled "When It Comes to Coverage for Cyber Crime Losses, Is Your Loss 'Direct' Enough?" (April 28, 2017)

Save the Date!

Fifth Annual Insurance Coverage Conference
October 12, 2017, 1:30 p.m. to 5:30 p.m.

Location:
Embassy Suites Independence
5800 Rockside Woods Blvd.
Independence, OH 44131