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RAISING THE BAR
Winter 2019

COMMITTEE NEWS

Professional Liability Insurance

Insurance Agent and Broker E&O 2018: The Year In Review

I. INTRODUCTION

The evolution of insurance agent and broker errors and omissions ("E&O") law has been highlighted in recent years by: continued erosion of the "duty to read" defense; increasing perceptions of agents and brokers as possessive of specialized experience and expertise necessary to advise and guide their customers with respect to their insurance coverages and overall risk management; and ever expanding E&O risk concerns. In 2018, while these trends did not abate, there were a number of positive developments for insurance agents and brokers as well. These include: decisions touching on choice of law analysis in resolving conflict of law issues; accrual of failure to procure claims for statute of limitations purposes; the continued vitality of the "duty to read" defense in a number of states; and even the continued viability, in certain jurisdictions, of the absolute defense of contributory negligence on the part of the insureds.

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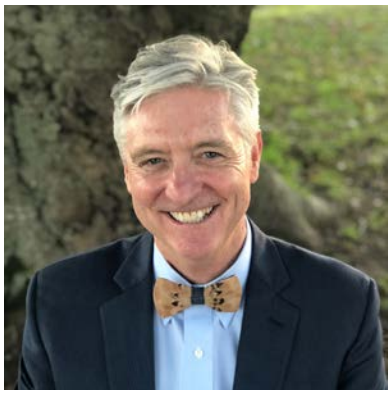

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Dear PLIC members:

Tim and I are very excited to bring you this Quarterly Newsletter, with articles on Insurance Agent and Broker E&O, D&O Coverage Litigation for Securities Appraisal Actions, and Lessons Learned: D&O Coverage for Appraisal Litigation Claims. We also have a fun and fascinating Industry Spotlight feature on **Teresa Milano**, AVP Claims at Starstone. We hope you find the information both interesting, fun and useful to your practices. If you want to contribute to future newsletters, please contact our Newsletter Editor **Jennifer Feldscher**, at jfeldscher@goldbergsegalla.com.

The month of February was a very eventful one for the Professional Liability Insurance Committee, with the Committee co-sponsoring a half day Conference at Fordham Law School entitled Disasters: The Emerging D&O, E&O and Corporate Issues. We had a sold out presentation, and three terrific panels. We are already planning for next year's conference. If you have ideas please submit them to Tim or me.

In March, we had the first of our guest speakers during our monthly conference calls: **Marygrace Schaeffer** of DecisionQuest. Marygrace gave an incredibly interesting and informative presentation on the science of trying damages to juries. Our next call, on April 2nd, will feature a presentation from Thomson Reuters-West on use of AI as a litigation tool.

If you haven't already done so, we urge you to sign up for the TIPS Section Conference in May. There is an incredible lineup of presentations and speakers, and a dinner planned at the famed Rainbow Room at Rockefeller Center. We will be hosting drinks and a dinner on Wednesday, May 1st. Please let Tim and I know if you will be attending so we can make reservations.

Lots more to come this year. We're very glad you are all a part of it.

Thanks,

Peter and Tim

Editor Message

Dear PLIC members:

If you want to submit an article for inclusion in the Spring Newsletter, please send it to my attention (jfeldscher@goldbergsegalla.com) by April 30, 2019. We also welcome submissions from non-members.

Thanks,

Jennifer Feldscher

Jennifer Feldscher, Esq.
Goldberg Segalla, LLP

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D&O Coverage Litigation for Securities Appraisal Actions

January 29, 2019

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In the context of a merger or acquisition, Delaware General Corporation Law §262 ("Delaware §262") provides an equitable remedy that allows shareholders of a publicly held company being acquired to dissent to the so-called "deal price" in the merger, and it appoints the Delaware Chancery Court to appraise the value of their stock shares. Other states also have similar securities appraisal statutes.[1] Under Delaware §262, dissenting shareholders receive the appraised value of their stock, as determined by the Chancery Court, which could be lower, higher or the same as the merger price. Additionally, Delaware §262 appraisal petitioners can recover annual interest at 5% over the federal discount rate compounded quarterly from the date of the merger until the appraisal action concludes.

Obtaining a return of 5% annual interest compounded quarterly over a very low federal discount rate has attracted enterprising and sophisticated investors to dissent to mergers and institute Delaware §262 appraisal actions.[2] In some instances, the Delaware §262 appraisal petitioners have reaped enormous profits from their Delaware §262 appraisal actions resulting from an increase in the stock share price, plus the statutory interest. In other instances, the dissenting shareholders have made significant money on the statutory interest alone; even when the Chancery Court determines that the fair value of the stock is less than the merger price. Accordingly for certain investors and their litigation counsel, Delaware §262 appraisal actions can be a highly lucrative litigation opportunity.

Since 2016, at least three acquired companies that litigated securities appraisal proceedings to eventual settlements have brought coverage actions against their Directors and Officers ("D&O") insurers to recover their costs of defending the securities appraisal actions, and in two of the cases, the Delaware §262 statutory interest components of the settlements as well.[3] The issue of first impression raised in these cases is whether the settlement of and the attorneys fees incurred in defending a securities appraisal proceeding are covered under the acquired company's D&O insurance policies. These claims involve significant amounts of money. For example, in *Zale v. Liberty,* Zale is seeking over $30 million in coverage. In *Solera Holdings v. XL*, Solera Holdings is seeking over $50 million in coverage.

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INDUSTRY SPOTLIGHT

Teresa Milano, Esq.
AVP Claims, Management and Professional Liability, StarStone

1. How did you first become involved in working in the insurance industry?

I fell into it. I obtained an undergraduate degree in business but always had an affinity towards law. After working in management consulting for a few years, I decided to go to law school with aspirations to marry business and law in a non-law firm setting. While studying for the Bar, I applied and was hired to work for HCC Insurance (now Tokio Marine) as a Claims Attorney, which was a good blend of two worlds. Needless to say, ten years later, I am still here.

2. What types of claims do you oversee at StarStone?

I am the Head of the Management and Professional Liability claims, which include numerous lines such as public D&O, private EPL, lawyers malpractice, media/music, A&E, and real estate. The variety of policy types requires the team to wear multiple hats, which can be challenging at times, especially given that most of the policies are duty-to-defend. That being said, I think the variety keeps us all challenged and there certainly is never a dull moment.

3. Are there particular claim trends you see as developing issues of concern?

The continued upward trend of securities litigation and the costs associated with it– will it ever end? I wish I could say yes. Additionally, we see a lot more claims related to real estate transactions from all sides- the title agent, real estate agent and lawyer.

4. When you are dealing with claims with potentially significant exposures, what do you see as the keys to successfully navigating the coordination of efforts on the part of the primary E&O carrier, excess counsel, defense counsel and the insured?

Proactivity, communication and continuous evaluation throughout the life of a claim. These are all critical in trying to resolve the case early, keeping costs down, and ensuring the best strategy is utilized.

5. Tell me about how you became the President of the Northeast Barbeque Society (NEBS)?

My husband and I are barbeque aficionados- whether it is reading about BBQ, smoking meats in our backyard or visiting barbeque restaurants – we love it all. Several years ago, I discovered NEBS and we became members. Last year, I served on the Board of Directors and this year, I was nominated to be President, which I graciously accepted. Our focus is to promote the traditions, lifestyle, and skills associated with barbecuing, slow smoking, cold smoking, and grilling. This year we will be focusing in on non-competition related events and making more ties with the community.

Lessons Learned: D&O Coverage for Appraisal Litigation Claims

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Shareholder litigation challenging M&A deals is nothing new to D&O insurers. Nor are the insurance coverage issues that frequently arise in connection with deal litigation. However, in recent years, a different kind of deal litigation has become more common. A tactic known as appraisal arbitrage is a tool that strategic investors have used to a larger degree to squeeze additional value out of corporate mergers. Insurers and policyholders have found that standard D&O policy terms and conditions do not always squarely answer whether and to what extent D&O policies provide coverage for appraisal litigation claims. Although coverage disputes on this issue have gone into litigation, the courts have not had to decide these disputes in a way that provides clear guidance on whether appraisal litigation claims are covered. However, lessons learned from the coverage issues that have come up in appraisal litigation will help D&O insurers and policyholders alike stake their positions if and when disputes over coverage for appraisal litigation arise in the future or eliminate uncertainty regarding coverage through policy drafting.

What is Appraisal Litigation?

Appraisal litigation is a creature of statutory law. The corporations code of many states give minority shareholders who dissent to a merger the ability to seek a judicial appraisal of the fair value of the shares they are forced to give up in a merger. For example, Section 262 of the Delaware Corporations Code[1] provides that a dissenting stockholder "shall be entitled to an appraisal by the Court of Chancery of the fair value of the stockholder's share of stock." An appraisal claim tests the fair value of the stock prior to merger based on the company as a going concern. The dissenting shareholder receives the fair value, plus interest and attorneys' fees. In the Delaware statute, interest is calculated at 5% over the Federal Reserve discount rate. Therefore, even if the fair value determined in the appraisal is lower than the merger price, an interest award can result in a recovery to the investor that more than makes up for the difference between what the investor would have received in the merger and the fair value as determined in the appraisal. And the ability to recover attorneys' fees gives investors and their counsel an incentive to engage in appraisal arbitrage. In fact, in the typical appraisal arbitrage, the appraisal action is brought by a shareholder who acquired shares after a merger has been announced for the sole purpose of pursuing appraisal and the enhanced interest that it provides.

An appraisal of fair value does not necessarily involve an evaluation of the corporation's or its directors' conduct in pursuing and executing a merger. An appraisal of fair

value is purely an economic analysis. A court could determine that a merger price does not reflect fair value without finding that directors breached fiduciary duties to the corporation, acted under a conflict of interest or engaged in any other conduct that was improper. For example, a case pending before the Delaware Supreme Court, *Verition Partners Master Fund Ltd, et al. v. Aruba Networks, Inc.*,[2] will decide whether a company's average share price for a period of time prior to a merger announcement is an appropriate measure of fair value. And in 2017, the Delaware Supreme Court issued two decisions that indicate that although a fairly negotiated deal price is a potentially strong indicator of fair value, it is not presumed to be fair value.[3] And, in *Blueblade Capital Opportunities LLC v. Norcraft Companies, Inc.*,[4] the Delaware Chancery Court held that a deal price did not reflect the company's fair value because of significant flaws in the sale process. Therefore, while it is possible that an appraisal action can be decided without putting the actions of the company or its directors under review, an investor will almost certainly pursue and present such evidence to refute any argument that the deal price represents fair value and to find fault in the sale process in which the deal price was determined. Therefore, appraisal litigation can, and often does, examine the corporation's and its directors' conduct in agreeing to a price for the company's shares in the transaction.

An Appraisal Litigation Coverage Dispute

Recent coverage litigation in Texas is instructive of the types of issues that can arise when D&O coverage for an appraisal claim is disputed. In *CEC Entertainment, Inc. v. Travelers Casualty and Surety Company of America*,[5] an insurer and policyholder litigated whether a D&O policy provided coverage for defense costs the policyholder incurred in connection with responding to a statutory appraisal action.

The underlying appraisal action arose out of the February 2014 merger of CEC Entertainment, Inc. and Q Merger Sub, Inc. Pursuant to the merger agreement, shares of CEC common stock were automatically cancelled and converted into a right for shareholders to receive a cash payment of $54.00 per share. After the merger, dissenting shareholders of CEC brought an appraisal action against CEC (a Kansas corporation) under the Kansas Appraisal Statute[6] in which they asked the court to determine and direct payment by CEC of the "fair value" of their shares at the time of the merger, along with statutory interest. CEC sought coverage for the appraisal claim from its D&O insurer.

CEC's D&O insurer denied coverage primarily because the appraisal action did not allege a "Wrongful Act" by CEC. The policy defined "Wrongful Act" to include any actual or alleged "error, misstatement, misleading statement, act, omission, neglect, or breach of duty committed or attempted…by the Insured Organization." In the

ensuing coverage litigation, the insurer argued that the shareholder's complaint in the appraisal action did not allege a "Wrongful Act" by CEC. Specifically, the insurer asserted that an appraisal action is purely a statutory mechanism that permits a court to make an independent determination of the fair value of the company's shares, which does not require an adjudication of any wrongdoing in the transaction. Therefore, the insurer argued, because CEC was not being sued for a "Wrongful Act," the D&O policy did not provide coverage. CEC responded that the term "Wrongful Act" was not defined in a way that required wrongdoing by the insured. Rather, "Wrongful Act" included any "act" by CEC. CEC claimed its acts in valuing its stock and setting and approving the price of its shares are the "acts" for which the appraisal action was brought, thus triggering coverage. CEC further argued that even if wrongfulness was required, the court could infer that the appraisal action was brought based on an alleged unfair, incorrect, wrong, or otherwise inadequate valuation of the shares by CEC.

The Texas court never had to decide this issue because CEC and its insurer reached a settlement before the court ruled on summary judgment. But the dispute highlights an issue that courts may be called on to decide in the future.

Does an Appraisal Action Involve a "Wrongful Act"?

As with nearly all coverage disputes, the starting point is the policy language. The typical definition of "wrongful act" and how it applies in appraisal litigation provides fertile ground for disagreement between insurers and policyholders. The D&O policy's definition of "wrongful act" that was the source of dispute in the CEC litigation is like the definition of the term found in many D&O policies. In CEC's policy, "Wrongful Act" was defined to mean:

> Any actual or alleged error, misstatement, misleading statement, act, omission, neglect or breach of duty committed or attempted by the Insured Organization.

Insurers can argue that an appraisal claim does not involve a "wrongful act" because the claim involves an economic evaluation of the fair value of the stockholder's stock without an adjudication of wrongdoing on the part of the company or its directors. Insurers have pointed to the Delaware Supreme Court's statement that "there is one issue in an appraisal trial: 'the value of the dissenting stockholder's stock.'"[7] In addition, a complaint in an appraisal action need not allege wrongdoing by the corporation or its directors. A dissenting stockholder bringing an appraisal action need only allege that it was a stockholder of record, that it dissented to the proposed merger, that it did not accept consideration for its stock in connection with the

merger, that it had demanded appraisal, and that it is entitled to a determination of fair value under the applicable appraisal statute.

Policyholders' arguments in response have pointed to the fact that the definition of "wrongful act" includes any *act* by the insured, regardless of wrongfulness. Therefore, policyholders have argued that the merger at the established share price is the wrongful act for which the D&O policy provides coverage. In addition, policyholders argue that if the merger price does not reflect fair value, as plaintiffs in appraisal actions contend, the merger must be the result of some error, omission of breach of duty by the company or its directors in valuing the company or negotiating the merger price. Policyholders also argue that although an appraisal action complaint need not, and often does not, allege wrongdoing or errors by the company or its directors, the process of establishing fair value in appraisal litigation will involve claims of some error, omission or breach of duty. For example, appraisal litigation often involves claims of directors' conflicts of interest or deficiencies in the company's process in determining the merger price. Often such claims are necessary to overcome a presumption that a merger price arrived at in an arm's-length transaction between the parties to the merger represents fair value. Therefore, policyholders argue a wrongful act can be inferred even if an appraisal action complaint does not expressly allege wrongful acts.

While the facts and circumstances that these arguments are based on are unique to appraisal litigation, the concepts underlying them are ones that frequently arise in coverage litigation. Case law interpreting similar definitions of "wrongful act" or similar wording in D&O and E&O policies is abundant and will assist both insurers and policyholders in crafting arguments over whether any act by the insured qualifies as a "wrongful act," regardless of a breach of duty, error or other improper action. Likewise, traditional "duty to defend" case law on how strictly the allegations within the four corners of a complaint will be construed, whether the court should consider reasonable inferences that can be drawn from the allegations and the ability of courts to consider extrinsic evidence provide the framework for arguments over whether a sparsely detailed complaint in an appraisal action asserts a claim based on a covered "wrongful act." Therefore, even in the absence of court decisions interpreting a D&O policy in the context of an appraisal claim, counsel for insurers and policyholders alike will find case law in nearly every state that will provide a foundation for arguments in the unique context of these claims.

In addition, there are lessons to be learned from the issues that were litigated in the CEC coverage case. The case highlights areas of opportunity for insurers and

policyholders to negotiate policy terms so that how a D&O policy will respond to appraisal litigation is more clearly stated.

The future of appraisal actions is in question. The Delaware Supreme Court's anticipated decision in the *Aruba Networks* case will shape the future of appraisal litigation in Delaware and likely influence appraisal litigation in other states. One outcome could be requiring a dissenting shareholder to prove breach of fiduciary duty by a corporation's directors or some other wrongful act that caused the merger price not to reflect fair value. Whatever the outcome, it will surely have ramifications on future appraisal actions and D&O coverage disputes that may follow.

Endnotes

1 Del. Code Ann. tit. 8, § 262 (West).

2 Delaware Supreme Court, C.A. No. 368, 2018.

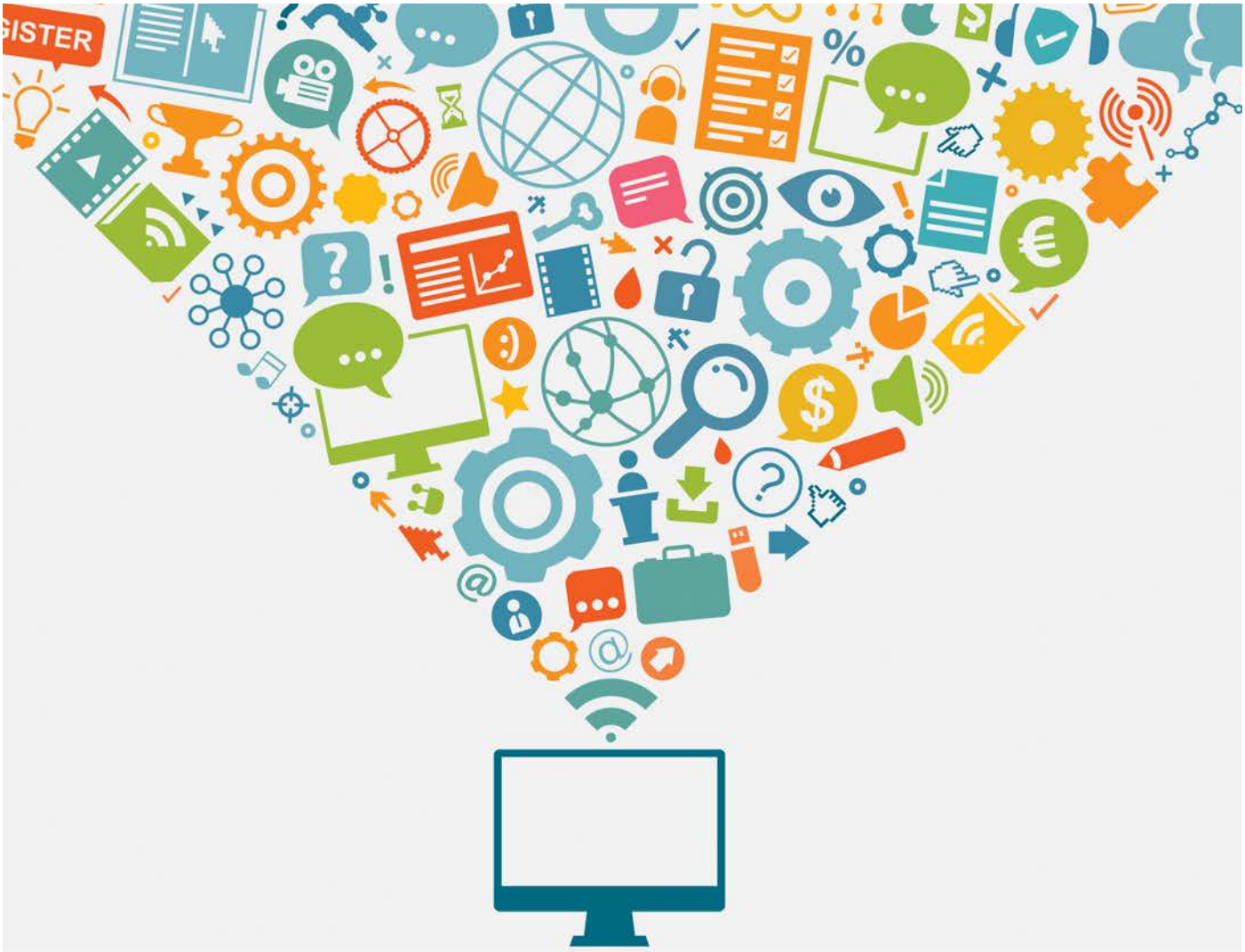
3 *Dell, Inc. v. Magnetar Glob. Event Driven Master Fund Ltd.*, 177 A.3d 1 (Del. 2017); *DFC Glob. Corp. v. Muirfield Value Partners, L.P.*, 172 A.3d 346 (Del. 2017).

4 *Blueblade Capital Opportunities LLC v. Norcraft Companies, Inc.*, No. CV 11184-VCS, 2018 WL 3602940 (Del. Ch. July 27, 2018), *judgment entered,* (Del. Ch. 2018).

5 United States District Court for the Northern District of Texas, Case No. 3:16-CV-02493-M.

6 Kan. Stat. Ann. § 17-6712 (West).

7 *Dell, Inc.*, 177 A.3d at 20.



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Insurance Agent... continued from page 1

Additionally, there were some helpful decisions in regards to defining the parameters of what constitutes an "interaction with regard to a question of coverage" sufficient to give rise to a duty to advise, and what is necessary to establish "special circumstances" or a "special relationship" based on an "extended course of dealing".

The following is a summary of some of the more interesting and significant developments in insurance agent/broker E&O in 2018.

II. SUMMARY OF THE YEAR'S HIGHLIGHTS

A. Choice of Law

In an important decision addressing the question of which state laws apply to claims against a broker where the alleged broker misconduct is claimed to have occurred in one state and the alleged injury occasioned thereby in another, the U.S. District Court for the Southern District of New York held that, under New York choice of law rules the court must look to the law of the state where the alleged misconduct occurred. This appears to have resolved some significant confusion on the issue, and is expected to clarify that no longer should federal district courts venued in New York look to the place of injury in determining choice of law for conduct-regulating based issues.

In *Holborn Corp. v. Sawgrass Mut. Ins. Co.*,[1] Sawgrass Mutual was an insurer that wrote homeowners insurance coverage in Florida. It retained Holborn to procure reinsurance for same, but terminated the agreement a couple of years later, after which Holborn brought suit for breach of contract, alleging Sawgrass had failed to pay its full share of brokerage on all reinsurance procured or placed. In response, Sawgrass asserted counterclaims alleging negligence, breach of fiduciary duty and breach of contract based on Holborn's alleged failure to recommend "Top and Drop" reinsurance coverage, a multi-layer insurance product that allows the insured to re-use the top excess-of-loss layer of reinsurance if it is not breached by the first loss event. Sawgrass alleged that had Holborn recommended this coverage, it would have saved hundreds of thousands of dollars.

Holborn moved to dismiss the first and second counterclaims on the grounds that they were barred by the economic loss doctrine under New York law. In opposition, Sawgrass argued that Florida law should apply, and thus, the economic loss rule should not apply in this instance (as under Florida law the economic loss doctrine only applies to product liability claims). Because the law at issue was "conduct regulating" as opposed to "loss-allocating," the court concluded that New York law should apply based on the alleged negligence and breach of fiduciary duty taking place in New York, where Holborn's brokers were located. In so doing, the court

firm's Manhattan office. A longer version of this article was previously published in the 2019 First Quarter PLUS Journal, and is republished here with permission. Portions of the content of this article will also appear in the American Bar Association TIPS Journal Year in Review Winter issue, covering a broad range of professional liability and D&O developments in 2018.

noted some confusion in past precedent on the issue, as a number of courts had previously concluded that conduct-regulating laws should be applied utilizing the law of the state where the last event necessary for liability took place: *i.e.*, the situs of the injury. But applying the Second Circuit Court of Appeals' decision in *Licci ex rel. Licci v. Leb. Can. Bank, SAL,*[2] the court concluded that, in fact, where the alleged wrongful conduct and the alleged injury do not take place in the same jurisdiction, "[I] t is the place of the allegedly wrongful conduct that generally has superior 'interests in protecting the reasonable expectations of the parties who relied on [the laws of that place] to govern their primary conduct and in the admonitory effect that applying its law will have on similar conduct in the future.'"[3] Accordingly, because New York law applied, Sawgrass' counterclaims for negligence and breach of fiduciary duty were barred by the economic loss doctrine, and the claims dismissed.[4]

B. Statute of Limitations

In *American Fam. Mut. Ins. Co. v. Krop*,[5] the Illinois Supreme Court dismissed a negligence claim against an agent for allegedly failing to procure homeowner's insurance providing coverage "equal" to the plaintiffs' prior coverage. Because the replacement policy only provided coverage for liability arising from bodily injury or property damage, the insurer (American Family) had denied coverage for claims alleging defamation, invasion of privacy and intentional infliction of emotional distress not involving any alleged bodily injury.

As the policy in issue had been received by the plaintiffs more than 2 years prior to the plaintiffs' lawsuit, the agent moved to dismiss the claim as barred by Illinois' two year statute of limitations provided for under 735 Ill. Comp. Stat. Ann. 5/13-214.4 (2014). After the motion was initially granted, then reversed on appeal, the Illinois Supreme Court reversed the appellate court ruling, and dismissed the claim.

In issuing its decision in this regard, the Illinois Supreme Court rejected the plaintiffs' argument that the claim against the agent should not accrue until the discovery of the failure to procure the requested coverage occasioned by the denial of the insureds' claim. In so doing, the court noted that, under Illinois law, an alleged negligent failure to procure does not involve the breach of fiduciary duty.[6] And "[b]ecause a claim for negligent failure to procure insurance does not involve a fiduciary duty, insurance customers' obligation to read their policies controls."[7]

Detailing its rationale for why this constituted good public policy, the Court explained:

> Customers generally know their own goals better than an insurance agent does, but determining if a policy achieves those goals will be difficult when customers do not read their policies. Expecting customers

> to read their policies and understand the terms incentivizes them to act in good faith to purchase the policy they actually want, rather than to delay raising an issue until after the insurer has already denied coverage. Moreover, insurance customers frequently maintain the same insurance policy for years, perhaps decades, at a time. If the cause of action did not accrue until the insurance producer notified the customer of an uninsured liability, insurance customers would benefit from the policy throughout the intervening period, while evidence potentially relevant to the insurer's defense would be at risk of deterioration.[8]

In issuing this ruling, the Illinois Supreme Court noted that other courts in other states (including Alaska, Massachusetts, Maryland and Pennsylvania) had applied the "discovery rule," and still others had found that the cause of action only accrues when the insured incurs losses because of an uninsured liability.[9] However, the *American Family* Court stated that these courts had relied on two key premises, which the Court rejected: "that the injury for which the plaintiffs sought a remedy was a liability that their policy did not cover and that the plaintiffs could not assert their claim until they encountered such a liability."[10] Instead, the Court held that the failure to procure insurance is a tort arising out of breach of contract, and thus should be treated as a tort, which accrues when the breach occurs.[11]

Recognizing that there will be "a narrow set of cases in which the policyholder reasonably could not be expected to learn the extent of coverage simply by reading the policy," such as where the insurance policies contain contradictory provisions, fail to define key terms, or the circumstances of the loss in issue are so unusual that they could not likely have been imagined by the insureds when they purchased their policy, the Court indicated there could be exceptions to the rule.[12] But where, as here, the policy specifically contained a definitions section detailing the fact that "bodily injury" did not cover emotional or mental distress, mental anguish or mental injury "unless it arises out of actual bodily harm to the person," the Court concluded no such exception should be applied.[13]

Applying a different approach, in *Lederer v. Gursey Schneider LLP*,[14] a California appellate court considered the question of when a negligent failure to procure claim accrued in connection with alleged failure to procure requested uninsured/underinsured automobile insurance. In *Lederer*, the evidence was undisputed that the insured had requested $5 million in limits, but a policy with a limit of only $1.5 million was purchased. This was discovered shortly after the policyholder's adult son was severely injured in a motorcycle accident. More than 2 years after this—but less than 2 years after the insurer for the other driver had tendered the $15,000 limits on the other driver's policy and the plaintiff's insurer had tendered the $1.5

million limit of the underinsured motorist policy—the plaintiff policyholder and her son brought suit against the agent. Because the statute of limitations was 2 years, the agent moved for summary judgment, arguing that the plaintiffs' cause of action had accrued when plaintiffs had been alerted to the fact that the insurance coverage that had been purchased was less than what had been requested. The trial court granted the motion. On appeal, however, the ruling was reversed.

In reversing the trial court on this issue, the appellate court concluded that the trial court had conflated the question of when the discovery of the alleged negligence had occurred with the question of when the plaintiffs had incurred actual injury. Because actual harm is required before a cause of action for negligence accrues, the appellate court concluded it was only when the plaintiffs suffered harm as a result of the failure to procure the requested coverage limits that the cause of action accrued. In this case, although the plaintiff son clearly suffered damages from the motorcycle accident in February 2010, and plaintiffs discovered the negligent failure to procure shortly thereafter, the plaintiffs did not suffer damages *caused by the agent's negligence* until the son received the diminished benefit payment in June of 2012 — less than a year prior to the institution of the lawsuit. Significantly, in reaching this ruling the appellate court pointed to the fact that, under the governing statute, a right to underinsured motorist coverage does not accrue until the insured has reached a settlement or judgment exhausting the underinsured policy. In this case, the right to underinsured motorist coverage was not a given, because the cause of the accident was heavily disputed, and the police report of the accident was not favorable. It was not until the claim was settled with the underinsured motorist and the underinsured motorists coverage was tendered, in January 2012, that the injury caused by the failure to procure the requested underinsured motorist coverage limits was incurred.

In arguing in favor of affirmance of the trial court ruling, defendant argued that, in fact, the son had "suffered actual injury when he sustained severe bodily injuries exceeding his available insurance coverage, without any right to obtain any greater liability protection to fully compensate him for his injuries," and this "diminution of right" was sufficient to trigger the claim.[15] The appellate court rejected this argument, concluding that unless and until the son's right to receive any coverage under the underinsured motorist protections of the policy was extant, the mere "threat of future harm — not yet realized — does not suffice."[16]

Lastly, in *Penn v. 1st S. Ins. Servs., Inc.*,[17] a Virginia federal district court, applying Virginia law, dismissed a claim for breach of contract in failing to procure the requisite minimum liability coverage for a truck engaged in interstate commerce. Although the

federal minimum is $750,000, and it was alleged the owners relied on the broker's promised experience and expertise in insuring truckers to purchase the requisite coverage, the defendant broker purchased liability limits of only $100,000 for the truck. After two individuals were severely injured in an accident caused by the driver of the company's truck, they were awarded, collectively, $2.725 million in damages. The company assigned its claims against the broker to the injured parties, and the injured individuals brought suit against the broker for, among other things, breach of contract in failing to procure the required coverage. Because the claim was brought more than 5 years after the alleged breach of contract — *i.e.*, the failure to purchase the correct coverage — on motion to dismiss the claim as time-barred, the court granted the motion. In reaching this holding, the court noted that, under Virginia law, a cause of action accrues when injury is sustained. In this case, the court concluded the owners of the truck sustained injury when they received the wrong coverage.[18]

As the lawsuit had been commenced within a year after the plaintiffs obtained their verdicts against the company, the plaintiffs argued that, because the company was being defended in the personal injury action, it did not suffer an actual injury resulting from the alleged failure to procure the proper coverage until after judgments against it were obtained. However, in reasoning similar to that adopted by the Illinois Supreme Court in the *American* Family case discussed above, the *Penn* court pointed to the fact that, under Virginia law, in the case of a failure to procure a policy, the right to recover is fully matured when the agreement is violated, and the insured has been harmed in paying premiums for coverage that was not obtained.[19] Accordingly, while further injury was suffered when the judgments were obtained for which there was only $100,000 in coverage, the claim against the broker had accrued years earlier, "When the legally insufficient policy was placed by Defendants."[20]

This ruling, and the *American Family* ruling, are significant in the ongoing debate about accrual of negligent failure to procure claims in that, as courts that have struggled with the issue have noted, the fact that the requested coverage was not obtained may not make itself readily known until a loss occurs. Not surprisingly, the rule in a number of states is that the statute of limitations does not begin to accrue on such claims until a loss occurs evidencing the lack of coverage, because only then has the insured suffered injury. But the policy argument relied upon by the Illinois Supreme Court holds significant appeal, and the analysis in the *Penn* case supports the argument that, in fact, harm has been suffered immediately upon receipt of the wrong coverage. In light of the continuing evolution of the case law on this issue, it would not be surprising if, even in jurisdictions with apparently "settled" law on the issue, there may be further changes coming.

C. Defense of Unavailability of Coverage

In *Madison Cnty. v. Evanston Ins. Co.*,[21] the court considered the viability of a defense of unavailability of coverage to a failure to procure claim insofar as it is based on an alleged breach of a contractual promise to procure specific coverage under Alabama law. Finding this defense to be lacking, the court noted that in connection with breach of contract claims, Alabama "'has not recognized the defense of impossibility or impracticability. Where one by his contract undertakes an obligation which is absolute, he is required to perform within the terms of the contract or answer in damages, despite an act of God, unexpected difficulty, or hardship, because these contingencies could have been provided against by his contract.'"[22] Accordingly, under Alabama law, absent a contractual provision addressing the contingency of the requested coverage being unavailable, the defense that the coverage would not have been available—which is regularly raised as a defense to negligent failure to procure claims—is apparently *not* a viable defense to a breach of contract based failure to procure claim.[23]

D. Duty to Read

As regular readers of this annual review will note, the defense of "duty to read" has been under assault, and there are fewer and fewer jurisdictions which continue to view the "duty to read" as an absolute defense to negligent failure to procure and fraud or negligent misrepresentation claims. But there are still some jurisdictions in which the defense remains alive and well. A couple of decisions in Mississippi and Georgia reflect this, while at the same time highlighting the availability of exceptions to the rule even where it remains in place.

In *Am. Zurich Ins. Co. v. Guilbeaux*,[24] the court reaffirmed that, under Mississippi law, claims of negligent procurement, or fraudulent or negligent misrepresentation against a broker or agent must fail, as a matter of law, if the insured received and had an opportunity to review its insurance policy and a review of same would have clarified the actual coverage procured, based on Mississippi's "duty-to-read" and "imputed-knowledge" doctrines. However, the court noted that, "[f]or an insurer to get the benefit of a presumption of receipt of an insurance policy, the insurer must tender evidence of mailing—such as an affidavit of an employee demonstrating the insurer's records acknowledging mailing."[25] As the insured claimed to have been misled that the builder's risk policy he purchased would provide coverage for more than 30% of the completed work on the home he was constructing and there was no documentary evidence he had been provided with a copy of the policy, the court denied the broker's motion to dismiss on summary judgment.

The duty to read as an absolute defense to an insurance agent/broker negligent failure to procure claims remains viable in Georgia as well. But there are exceptions. *Bush v. AgSouth Farm Credit, ACA*[26] provides an illustrative example.

As a general rule, Georgia law provides that:

> An insurance agent who undertakes to procure a policy of insurance for his principal but negligently fails to do so may be held liable to the principal for any resulting loss. However, where the agent does procure the requested policy and the insured fails to read it to determine which particular risks are covered and which are excluded, the agent is thereby insulated from liability, even though he may have undertaken to obtain full coverage.[27]

However:

> an exception to this rule applies where the agent, acting in a fiduciary relationship with the insured, holds himself out as an expert in the field of insurance and performs expert services on behalf of the insured under circumstances in which the insured must rely upon the expertise of the agent to identify and procure the correct amount or type of insurance.[28]

In *AgSouth Farm Credit*, a farmer ("Bush") who had purchased crop insurance for his wheat and soybean crops, suffered a loss in 2013 to his wheat crop as a result of excessive moisture. He was paid $102,986 for his loss, which he assigned to AgSouth to put towards several loans he had received towards the purchase of farm machinery and equipment. Afterwards, the insurer conducted an audit of his claim and determined that he had misrepresented his actual production history ("APH"), and he was not entitled to the claim payment he received. The insurer demanded repayment of same in order for him to remain eligible to participate in the crop insurance program. Because he had used the funds to make payment towards his loan, he could not repay the insurer. Without the ability to purchase crop insurance, he contended he lost the ability to operate his farm in 2015 and 2016, had to sell off his cattle, and was forced to lease land and equipment to another farmer — causing him alleged damages of at least $145,000.

In pursuing claims for both negligence, negligent misrepresentation and fraud, Bush argued that the AgSouth agent he utilize to purchase crop insurance had agreed to calculate his APH each year beginning in 2011, and he presumed she had done so based on the "weight tickets" he had provided to her. The agent acknowledged she had prepared the APH calculations based on the information she was provided and told him he was not required to submit supporting documentation with his policy

application. But she claimed she had warned him that he would be subject to audit, and if he were ever audited, he would "have to document" what was reported in the insurance application. Further, Bush had signed the insurance application certifying that to the best of his knowledge and belief the information contained therein was correct; he signed the production and yield report submitted therewith certifying its correctness; the application stated "I also understand that failure to report completely and accurately may result in sanctions under my policy, including but not limited to voidance of the policy"; and, in signing the production report, he acknowledged "this form may be reviewed or audited and that information inaccurately reported or failure to retain records to support information on this form may result in recomputation of the APH yield."[29] Based thereon, AgSouth and the agent moved for summary judgment dismissing the claims, and the motion was granted.

On appeal, the decision was reversed. Although Bush admittedly had not read the policy and other related documents, the court noted that Bush had alleged that the agent had held herself out as a crop insurance expert. Further, viewing the evidence in the light most favorable to Bush, the court concluded there was evidence the agent had undertaken to calculate the APH for him, and Bush had relied on her expertise in this regard, because he knew nothing about crop insurance, having never previously farmed his land for the purpose of selling the produce, and thus, never having previously purchased such insurance. As such, Bush depended on the agent to ensure that his crop was adequately insured against loss, which necessarily required the agent to properly calculate the APH based on proper documentation as governed by federal rules set out in a voluminous Crop Insurance Handbook with which the agent was quite familiar.[30] As such, the court determined "[i]t is for a jury to decide whether [the agent's] alleged failure to ask Bush for records to support the APH and her alleged failure to use written verifiable records to calculate the APH constituted negligence and/or negligent misrepresentation."[31]

Significantly, while the defendants argued that the documentation requirement was readily apparent on the face of the application documents and policy, and Bush's admitted failure to read these documents preclude recovery, the court concluded that the fact that the expert exception to the general "duty to read rule" applied took the legs out from under that argument. In fact, the court noted, the policy referred to "written verifiable records," and relied upon reference to a federal regulation to define the term. As such, the court determined, "[i]t would not have been readily apparent to Bush, on the face of the policy, that the weight tickets or other information he provided to Meeks were not adequate to meet the definition of 'written verifiable record.'[32] Moreover, "[e]ven if Bush had read the policy from beginning to end, he would not have known that the calculation was not properly done in accordance with

federal regulations. Calculating the APH was up to the expert agent and governed by the rules set out in the Crop Insurance Handbook."[33]

E. Special Relationship/Duty to Advise

In *Hansmeier v. Hansmeier*,[34] the Nebraska Court of Appeals affirmed the dismissal of claims against an insurance agent on summary judgment asserting that the agent had been negligent in failing to advise a farmer regarding his coverage options. Although he had a right under Nebraska law not to purchase workers compensation insurance for his employees, he could only do so if he provided them written notice, signed by the employees, that they would not be covered by the Nebraska Workers Compensation Act. In this case, the farmer knew he did not have to purchase such insurance if he had ten employees or less, but was not aware that he had to provide this notice, and failed to do so, thus opening himself up to liabilities for an employee whose thumb was detached while using an auger on the job.

The appellate court found that the insurance agent's failure to advise the farmer of this notice obligation could not give rise to a negligent failure to advise claim, because the agent had no duty to anticipate what coverage the farmer should have. The court acknowledged the agent did not contradict the farmer when he advised he did not think he needed workers' compensation insurance. But it concluded this did not amount to a negligent misrepresentation, because it was true. In other words, reading between the lines of the decision, while it certainly would have been helpful to raise the question of whether the farmer had taken the requisite steps necessary to lawfully proceed without workers compensation insurance, the agent had no duty to anticipate that the farmer wasn't aware of or properly complying with the law, and as such anticipate his coverage needs based thereon.

In New York, there are three "exceptional situations" recognized by the courts as giving rise to a "special relationship:" "(1) [where] the agent receives compensation for consultation apart from the payment of the premiums; (2) there was some interaction regarding a question of coverage, with the insured relying on the expertise of the agent; or (3) there is a course of dealing over an extended period of time which would have put objectively reasonable insurance agents on notice that their advice was being sought and specially relied on."[35] While this is fairly straightforward and has long been the law in New York, the precise contours of what may constitute an "interaction with regard to a question of coverage" have not been specifically defined. As a result, arguments have been made that all sorts of "interactions" can form the basis of a special relationship, and the courts have had to grapple with this issue. Two federal court decisions applying New York law in 2018 have offered some guidance.

In *Holborn Corp. v. Sawgrass Mut. Ins. Co.*,[36] discussed above with regard to the choice of law issue, the court considered an alleged negligent failure to advise claim against a broker ("Holborn") for failing to advise an insurance company with a homeowner's insurance program to purchase "Top and Drop" reinsurance, a multi-layer insurance product that allows the insured to reuse the top excess-of-loss layer of reinsurance if it is not breached by the first loss event. As above noted, Sawgrass alleged that, had Holborn recommended this coverage, it would have saved Sawgrass hundreds of thousands of dollars. In rejecting Sawgrass' argument that there was a special relationship based on an "interaction regarding a question of coverage," the court noted that, "In order to satisfy this requirement, courts have generally required that the insured make a specific request about the feature of the proposed insurance at issue in the subsequent suit."[37] Yet, here Sawgrass had failed to allege that a particular conversation about the insurance coverage at issue had ever occurred, or that it had relied on Holborn to procure that coverage. Sawgrass had merely alleged that it had required the broker "to carefully analyze Sawgrass' potential exposure . . . [and] design a specific reinsurance program custom tailored to Sawgrass' unique business needs."[38] Similarly, the court noted, Sawgrass argued that Holborn had recommended a reinsurance policy "that it represented as having been the most advantageous for its unique business needs."[39] In rejecting this as an appropriate basis for a "special relationship" claim, the court stated:

> An alleged conversation in which the parties discussed 'the most advantageous' policy—without either party specifically mentioning Top and Drop insurance—is insufficient to create a special relationship . . . . All insurance customers are seeking the most advantageous insurance policy, and as a result, a discussion generally about what policy will be the most advantageous does not suggest 'that the Plaintiff enjoyed anything other than an ordinary consumer-agent insurance relationship.'[40]

Subsequently, in *Spinnato v. Unity of Omaha Life Ins. Co.*,[41] the court cited *Holborn* in dismissing a claim based on alleged negligent advice by an insurance agent, who allegedly had advised the plaintiffs to purchase insurance policies they ultimately could not afford, and caused them to be harmed as a result. In rejecting their special relationship claim based on an alleged interaction with regard to a question of coverage, the court noted that "[t]he Plaintiffs have failed to allege that a conversation occurred between themselves and [the agent] regarding the applicability of the policies to their particular financial situation, the affordability of the premiums, or the suitability of the death benefits."[42] Further, the court stated, the vague allegation that the Plaintiffs agreed to purchase the policies at issue based on the agent's recommendations was "too vague and common to create a special relationship."[43] If

the court was to rule otherwise, it concluded, the courts would be compelled to find a special relationship in nearly every instance, and "'th[is] exception would swallow the general rule.'"[44]

In addition to these significant New York federal court decisions, at the end of the year, the Alabama Supreme Court issued what could turn out to be an important decision on the duty to advise, affirming an Alabama Circuit Court decision dismissing claims against an insurance agent for alleged negligence in failing to advise a mattress manufacturer to purchase business interruption loss coverage. *See Somnus Mattress Corp. v. Hilson*.[45] The plaintiff manufacturer argued that the agent should be held responsible for the uninsured loss he suffered following a fire that destroyed a mattress factory, which ultimately ended up putting the manufacturer out of business. But the Court held that an insurance agent/broker generally does not have a duty to advise and cannot be deemed to have assumed a duty to advise absent evidence either that (1) the insurance agent/broker misrepresented the coverage in a manner that the insured could not have known from a reading of the insurance policy, or (2) the agent/broker and insured were in a "special relationship."

In issuing the decision, without setting any bright line rules for when a special relationship may arise, the Court took note of decisions in other states discussing when a "special relationship" can be found, and in so doing, appears to have implicitly accepted the following as bases for finding of a special relationship:

- Where the agent/broker has entered into an express agreement to provide coverage advice
- Where there has been a long established relationship between the insured and the agent/broker of entrustment from which it clearly appears the agent/broker appreciated the duty of giving advice to the insured client, and the client's reliance upon same
- Receipt of compensation by the agent/broker for consultation and advice separate and apart from receipt of commissions on premiums paid
- The offering of expertise with regard to a question of coverage where the insured relied on the agent/broker's expertise in making a coverage decision
- Where an ambiguous request has been made for coverage that requires a clarification[46]

Because it found that none of "the types of elements that trigger such a duty were . . . present in this case,"[47] the Court concluded that no basis existed for finding the defendant insurance agent owed a duty to advise the plaintiff to purchase business

interruption coverage arising from fire loss, and thus affirmed the dismissal of the plaintiff's claims on summary judgment.

This decision could prove to be significant. The Alabama Supreme Court did not lay out its professed standard for when a special relationship can be found to exist. But in engaging in an examination of and discussion of the grounds other courts have relied upon for finding of a special relationship, the Court can arguably be deemed to have implicitly adopted these standards for use by Alabama state courts going forward.

F. Measure of Damages

In *Lexington Club Cmty. Ass'n, Inc. v. Love Madison, Inc.*,[48] two condominium associations had paid the premiums on a performance bond purchased in connection with repair work to be done after Hurricane Wilma. In violation of the specific contractual requirements for the purchase of such a bond, the bond had been issued by a surety that was not licensed to do business in Florida. While there ended up being no cause to collect on the bond, the associations sued to recover the cost of the premiums from both the contractor and the insurance agent that had procured the bond, with the claim against the agent based on alleged negligence in failing to procure the requisite coverage.

At trial, the parties disputed the applicable jury instruction to be given on damages, with the associations contending that the jury should be instructed that, "[I]n an action for negligent procurement of insurance, . . . [w]hen no loss has occurred that would have been covered, if the insurance had been properly obtained, the measure of damages is the amount paid for the premium."[49] In contrast, the agent argued that the jury should be instructed that the measure of damages should be solely limited to the amount of uncovered loss that would have been covered had the insurance been properly obtained.[50] Because the court gave the insurance agent's instructions and there had been no loss, the jury concluded the associations had suffered no damages based on the agent's negligent failure to procure.

On appeal, the appellate court concluded the jury instruction was proper. The court noted that both Louisiana, Mississippi and Virginia had concluded the insured's damages in such instance should be measured by the amount paid in premium for the deficient coverage. However, the court found that by statute Florida provides that if a loss occurs under a policy issued by a non-authorized insurer, the policy would still be enforceable.[51] Thus, because the Florida Legislature had "expressly made the unauthorized insurer's policies enforceable in a negligent procurement action," the associations could not be held to have been injured by the purchase of the surety bond in issue.[52] In so finding, the court stated, "We decline to adopt the damages law of foreign states where our Legislature has provided statutory remedies."[53]

III. CONCLUSION

As 2018 has again shown, like its predecessors, the law of insurance agent/broker E&O continues to evolve in ways that provide both opportunity and peril for both sides of the "v" in agent/broker E&O litigation. Where there may be obvious mistakes made, defenses — even complete defenses — may still be available. And the statute of limitations battleground appears far from fully resolved, with the "discovery rule" enduring some setbacks. On the other hand, where the coverage issues are complex, the agent/broker has touted his expertise, and reliance thereon can be credibly argued, agent/brokers continue to face increasing risk. The careful practitioner should keep attuned to the trends, and "stay tuned."

Endnotes

1 Holborn Corp. v. Sawgrass Mut. Ins. Co., 304 F. Supp. 3d 392 (S.D.N.Y. 2018).

2 Licci ex rel. Licci v. Lebanese Canadian Bank, SAL, 739 F.3d 45 (2d Cir. 2013).

3 Holborn Corporation, 304 F. Supp. 3d at 399 (quoting Licci ex rel. Licci, 739 F.3d at 50–51).

4 Interestingly, a different analysis applies with respect to loss-allocating rules. Under New York law, there is a three step analysis to consider. *See* Neumeier v. Kuehner, 31 N.Y.2d 121, 286 N.E.2d 454, 177 (1972). There is still another analysis to consider with regard to applicable statutes of limitations. *See* N.Y. C.P.L.R. 202 (McKinney) (2018).

5 Docket No. 122556, Am. Family Mut. Ins. Co. v. Krop, 2018 IL 122556, *reh'g denied* (Nov. 26, 2018).

6 *Id.* at *5.

7 *Id.* at *6.

8 Id.

9 Id.

10 Id.

11 *Id.* at *7.

12 Id.

13 Id.

14 Lederer v. Gursey Schneider LLP, 22 Cal. App. 5th 508, 231 Cal. Rptr. 3d 518 (Ct. App. 2018), *review denied* (July 11, 2018).

15 Id. at 522.

16 Id. at 522–523 (quoting Adams v. Paul, 11 Cal. 4th 583, 904 P.2d 1205, 1208 (1995).

17 Penn v. 1st S. Ins. Servs., Inc., 324 F. Supp. 3d 703 (E.D. Va. 2018).

18 Id. at 713.

19 Id. at 710–711 (citing Autumn Ridge, L.P. v. Acordia of Virginia Ins. Agency, Inc., 270 Va. 83, 613 S.E.2d 435, 440 (2005).

20 Id. at 712.

21 Madison Cty. v. Evanston Ins. Co., 340 F. Supp. 3d 1232 (N.D. Ala. 2018), *as amended* (Nov. 2, 2018).

22 *Id.* at *31 (quoting Silverman v. Charmac, Inc., 414 So. 2d 892, 894 (Ala. 1982) (internal quotations omitted).

23 Id.

24 Am. Zurich Ins. Co. v. Guilbeaux, 2018 WL 1661629 (S.D. Miss. Apr. 5, 2018), at *5.

25 Id.

26 Bush v. AgSouth Farm Credit, ACA, 346 Ga. App. 620, 816 S.E.2d 728 (2018), *cert. denied* (Mar. 4, 2019).

27 Atlanta Women's Club, Inc. v. Washburne, 207 Ga. App. 3, 4, 427 S.E.2d 18 (1992) (citations omitted).

28 Id.

29 Bush, 816 S.E.2d at 733.

30 Id. at 736.

31 Id.

32 Id.

33 Id.

34 Hansmeier v. Hansmeier, 25 Neb. App. 742, 912 N.W.2d 268 (2018).

35 Voss v. Netherlands Ins. Co., 22 N.Y.3d 728, 735, 8 N.E.3d 823 (2014).

36 Holborn Corporation, 304 F. Supp. 3d 392.

37 Id. at 404.

38 Id.

39 Id. at 405.

40 Id. (quoting Long Beach Rd. Holdings, LLC v. Foremost Ins. Co., 75 F. Supp. 3d 575, 590 (E.D.N.Y. 2015)).

41 Spinnato v. Unity of Omaha Life Ins. Co., 322 F. Supp. 3d 377 (E.D.N.Y. 2018).

42 Id. at 393.

43 Id.

44 Id. (quoting Holborn Corporation, 304 F. Supp. 3d at 405).

45 Somnus Mattress Corp. v. Hilson, No. 1170250, 2018 WL 6715777 (Ala. Dec. 21, 2018).

46 *See id.* at *7-9.

47 *Id.* at *10,

48 Lexington Club Cmty. Ass'n, Inc. v. Love Madison, Inc., 253 So. 3d 632 (Fla. Dist. Ct. App. 2018).

49 Id. at 635.

50 Id.

51 Id. at 636 (referencing Fla. Stat. § 626.901(3) and 627.418(1) (2017)).

52 Id.

53 Id. at 637.

D&O Coverage... continued from page 7

In *Zale v. Liberty,* Zale Corporation ("Zale") filed suit against the insurers in its D&O coverage tower to obtain coverage for its $34.2 million settlement and over $6 million in attorneys fees and other costs incurred in defending Delaware §262 appraisal actions emanating from the corporate merger of Zale into Signet Jewelers Ltd. ("Signet") in 2014. For the Zale-Signet merger, the Delaware §262 annual interest rate was calculated at 5.75%. The settlement agreement did not allocate what portion of the settlement was attributable to an increase in the price of petitioners shares of Zale stock and what portion of the settlement was attributable to Delaware §262 statutory interest. By reference, 5.75% annual interest compounded quarterly for the 15 months between the date of the Zale-Signet merger and the settlement of the Delaware §262 appraisal actions on the approximately $181 million in merger consideration for Delaware §262 appraisal petitioners' shares of Zale stock is $13.1 million

Currently, *Zale v. Liberty* is in the middle of discovery. Of great interest to D&O insurers, policyholders and the D&O coverage bar will be the parties' dispositive motions, which are currently due in mid-March 2019. Meanwhile, *Solera Holdings v. XL* has only recently been filed, and it has not yet progressed to any discovery or motion practice.[4]

On the one hand, Zale is taking the position that the Delaware §262 appraisal actions filed against it invokes its D&O policies Securities Action Liability coverage insuring agreement, because they involve claims for wrongful acts. On the other hand, the insurers counter that Delaware §262 appraisal actions do not involve a wrongful act; but even if they do, they are excluded from the definition of loss due to the operative policy's "bump-up" exclusion.[5]

I. Do securities appraisal actions involve a wrongful act?

The issue of whether appraisal actions involve a wrongful act will be front and center in the upcoming summary judgment motion practice in *Zale v. Liberty.* Meanwhile, this issue was the focus of two sets of dispositive motion briefing and two lengthy court hearings presided over by Northern District of Texas Chief Judge Barbara Lynn in the now-settled *CEC Entertainment v. Travelers* litigation.

CEC Entertainment argued that the definition of "wrongful act," which includes "any actual or alleged error, misstatement, misleading statement, act, omission, neglect or breach of duty, actually or allegedly committed by the Insured Persons," encompassed CEC Entertainment's decision to agree to merge at an allegedly inadequate share price. In this regard, CEC Entertainment argued that pursuant to its definition, a "wrongful act" need only be an "act," and it does not have to be

wrongful to satisfy the definition. CEC Entertainment also argued that although a securities appraisal action remedy is equitable, the decision process involved in agreeing to a low merger price is wrongful anyway, because the shareholders launched the appraisal action based on what they believed to be the improper valuation of their shares. "Absent this allegedly unfair valuation, no appraisal action would have been brought in connection with the merger and cancellation of their shares."

Travelers; however, argued that "[t]he only conduct of CEC that has any relation to the appraisal action was the merger itself, which is neither wrongful nor improper and does not constitute a wrongful act." The argument continues that the nature of the acquired company's conduct is irrelevant, because securities appraisal statutes do not require bad conduct or unfairness, and they do not consider whether any wrongdoing occurred. Rather, D&O insurers argue that securities appraisal actions are no-fault accounting exercises. According to Travelers, "[b]ecause the appraisal action was not brought against CEC 'for a wrongful act' by CEC, it does not constitute a claim or a securities claim as defined in the policy."

In analyzing whether a "wrongful act" must be wrongful during the motion for summary judgment hearing, Judge Lynn recounted a presentation at a federal court judicial conference by the late U.S. Supreme Court Justice Antonin Scalia and Dallas based legal writing scholar Bryan Garner. As part of their program, they discussed the Latin doctrine *noscitur a sociis*, i.e., "a word is known by the company its keeps." According to the Texas Supreme Court, the purpose of *noscitur a sociis* is "to avoid ascribing to one word a meaning so broad that it is inconsistent with its accompanying words." At the hearing, Judge Lynn wondered aloud about the potential applicability of the doctrine, however, in light of the settlement, it was never decided.

II. Does the bump-up exclusion negate coverage for securities appraisal actions?

Another issue in *Zale v. Liberty* and *Solera Holdings v. XL* Delaware involves whether the appraisal action settlements constitute a "Loss" due to the operative policies' bump-up exclusion. The bump-up exclusion at issue in *Zale v. Liberty* in pertinent part provides:

> With respect to any Claim alleging that the price or consideration paid … for the acquisition of any securities issued … by any … entity is inadequate …, Loss shall not include the portion of any … settlement relating to the amount by which such price or consideration was

> changed or modified as a result of such Claim; however, this exclusion will not apply to Defense Costs.

Zale takes the position that the bump-up exclusion only pertains to the portion of the settlement related to the change in the share price, and it does not apply to Delaware §262 statutory interest component of the settlement or the costs involved in defending the Delaware §262 appraisal actions. Zale next argues that since the timing of the settlement of the Delaware §262 appraisal actions limited the amount of Delaware §262 statutory interest and defense costs that it otherwise would incur, the $34.2 million settlement of the Delaware §262 appraisal actions should be weighted heavier on the Delaware §262 statutory interest and defense costs than the simple mathematical calculation of the interest and the actual amount of the defense costs incurred. Zale also argues that since the Delaware §262 appraisal petitioners also agreed to release their claims on a covered fiduciary action, part of the $34.2 million settlement should be allocated to that covered claim.

Zale's insurers counter that the $34.2 million settlement figure was arrived at by increasing the share price from the merger price of $21 a share to $24.90 a share. Thus, they argue that the settlement is entirely attributable to a change in the share price. The insurers also contest Zale's position that due to its timing, the settlement should be weighted in favor of statutory interest and attorneys fees. Additionally, the insurers contend whatever amount of the settlement is attributable to Delaware §262 statutory interest, that amount still relates to the change of the share price. Accordingly, the insurers argue that the entire settlement is excluded by the bump-up exclusion.

III. What lies ahead for D&O coverage litigation for securities appraisal actions?

Studies show a steady increase in Delaware §262 appraisal actions from 2012 (when 20 were filed) to 2016 (when 48 were filed). In 2016, however, Delaware §262 was amended to provide a safe harbor to companies being acquired that provides relief with respect to the amount of Delaware §262 statutory interest. A Harvard Law School study indicates that the 2016 amendments resulted in a 33% decrease in the filing of Delaware §262 appraisal actions in 2017; although many Delaware §262 appraisal actions continue to be filed.[6]

So far, three securities appraisal action settlements have resulted in lawsuits seeking coverage on the acquired company's D&O policies. No express case law

guidance on the coverage issues has yet to emerge from this litigation. It remains to be seen whether D&O coverage litigation for securities appraisal actions will continue, increase or whether after the current lawsuits run their course, they will go away.

Endnotes

1 *See, e.g.,* KAN. STAT. ANN. § 17-6712 (West).

2 Some of these Delaware §262 appraisal action petitioners are arbitrageurs who do not purchase their stock in the to-be-acquired company until after upcoming merger plans are announced.

3 The initial securities appraisal action D&O coverage litigation was *CEC Entertainment, Inc. v. Travelers Cas. & Sur. Co. of Am.*, Civil Action No. 3:16-cv-02493 at one time on file in the United States District Court for the Northern District of Texas, Dallas Division, which involved the Kansas securities appraisal statute. CEC Entertainment only sought its attorneys fees and expenses incurred in defending the Kansas appraisal actions and it did not seek D&O coverage for an interest component of the appraisal action settlement. *CEC Entertainment v. Travelers* settled while competing motions for summary judgment were pending. *Zale Delaware, Inc. v. Liberty Insurance Underwriters, Inc., et. al.*, Cause No. DC-17-09200 is currently on file in the 14th Judicial District Court of Dallas County, Texas ("*Zale v. Liberty*"); and *Solera Holdings, Inc. v XL Specialty Ins. Co.*, Case No. N18C-315 AML, was recently filed in the Superior Court of the State of Delaware.

4 *Solera Holdings v. XL* is an example of a Delaware §262 appraisal action resulting in a lower share price than the merger price. There, the merger share price was $55.85. Although Solera Holdings incurred $13.5 million defending the Delaware §262 appraisal action, the Delaware Chancery Court found that the fair value of the merger share price was actually $53.95, almost $2 a share less than the merger price. After this finding by the Delaware Chancery Court, the parties agreed that the Delaware §262 statutory interest was valued at $38 million and then they settled the Delaware §262 appraisal action.

5 The parties are also raising other claims and defenses, which are not addressed in this casenote. For example, Zale is asserting that the Delaware §262 appraisal actions were interrelated wrongful acts to a covered shareholder fiduciary claim (which Zale won on summary judgment) and it is seeking extracontractual damages. The insurers are also claiming that the Delaware §262 appraisal settlement constitutes uninsurable restitution and by virtue of the timing of the merger, it is excluded by the run-off endorsement. Additionally, the insurers are raising improper notice and lack of consent to settle.

6 *See* Porter Wright Federal Securities Law Source blog: Delaware limits appraisal rights, but at what cost? Oct. 2, 2017.

Calendar

April 3-5, 2019	**Motor Vehicle Products Liability Conference** Contact: Janet Hummons – 312/988-5656 Contact: Danielle Daly – 312/988-5708	Hotel Del Coronado Coronado, CA
April 5-6, 2019	**Toxic Torts & Environmental Law Conference** Contact: Janet Hummons – 312/988-5656	Hotel Del Coronado Coronado, CA
April 12-19, 2019	**National Trial Academy** Contact: Juel Jones – 312/988-5597	Reno, NV
May 1-5, 2019	**TIPS Section Conference** Contact: Janet Hummons – 312/988-5656 Contact: Juel Jones – 312/988-5597 Speaker Contact: Arthena Little – 312/988-5672	Westin New York Times Square New York, NY
May 8-10, 2019	**Fidelity & Surety Law Spring Conference** Contact: Janet Hummons – 312/988-5656 Contact: Danielle Daly – 312/988-5708	JW Marriott Hotel Austin, TX
May 10-11, 2019	**Property Insurance Conference** Contact: Juel Jones – 312/988-5597	JW Marriott Hotel Austin, TX
August 8-11, 2019	**ABA Annual Meeting** Contact: Juel Jones – 312/988-5597 Speaker Contact: Arthena Little – 312/988-5672	San Francisco, CA
October 16-19, 2019	**TIPS Fall Leadership Meeting** Contact: Janet Hummons – 312/988-5656 Juel Jones – 312/988-5596	Grand Wailea Hotel Wailea, HI
October 24-25, 2019	**Aviation Litigation** Contact: Danielle Daly – 312/988-5708	Ritz-Carlton Washington, DC
November 6-8, 2019	**Fidelity & Surety Law Fall Conference** Contact: Janet Hummons – 312/988-5656 Danielle Daly – 312/988-5708	Hilton Boston Back Bay Boston, MA