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# The Rise of Cyber Insurance Liability Litigation

**By Chet Kronenberg and Tyler Bernstein**

As businesses are quickly learning, companies today have no choice but to confront the risks presented by the proliferation of cyber-based attacks targeting their confidential business information. Faced with this growing threat, many companies have begun taking steps to fortify security measures protecting their informational and technological infrastructure in the hope of preventing a cyber-attack. In addition, many companies have purchased cyber insurance liability policies that may provide indemnification and defense coverage following a cyber-based incident. This article examines four recent insurance coverage lawsuits stemming from a cyber-based incident.

## Cyber-Attacks

In this technological era, headlines lamenting massive data breaches are commonplace. For example, in 2013, Target Corporation suffered a well-publicized data breach that exposed private information concerning 40 million debit and credit card accounts. Then, in 2014, hackers supposedly affiliated with North Korea breached Sony Corporation's servers and leaked a wide range of highly sensitive business information. That same year, Home Depot

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# Is Coverage Hiding in Your Insured Contracts?

***Insurance Coverage Arising Out of Indemnification Agreements***

**By Paul A. Rose and Bridget A. Franklin**

Contractual liability frequently is excluded from coverage in Commercial General Liability ("CGL") policies. However, certain contractual liabilities, including "insured contracts," typically are covered under CGL policies as a result of exceptions to the general contractual liability exclusion. Policyholders may be less inclined to consider the prospects of such coverage when the "insured contract" is not characterized as an elevator maintenance agreement, a railroad sidetrack agreement, or some other type of agreement specifically referenced in the policy as being an insured contract.

In fact, however, CGL policies commonly define "insured contracts" as including that part of an agreement in which the insured assumes the "tort liability of another party to pay for 'bodily injury' or 'property damage' to a third person or organization." ISO form CG 00 01 12 04. In some polices, the indemnitee may even be included as an "additional insured," allowing an indemnitee to directly assert coverage under its indemnitor's insurance policy. In addition, some courts allow an indemnitee who is not listed as an "additional insured" to bring a direct action against an insurer.

Of course, policyholders and insurers are not always in agreement when it comes to interpreting the insured contract exception to the contractual liability exclusion. Courts often disagree with each other about such matters, as well. This article summarizes certain issues that may arise when a policyholder, or its indemnitee, asserts coverage for damages extending from an insured contract.

## Insured Contract Definition: How It Works

If there is an occurrence under the policy, a policyholder, or its indemnitee, may have a claim under the policyholder's CGL policy if the policyholder agreed

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to indemnify the indemnitee for third-party, non-contractual claims. Specifically, an "insured contract" may be defined as:

> That part of any other contract or agreement pertaining to your business (including an indemnification of a municipality in connection with work performed for a municipality) under which you assume the tort liability of another party to pay for "bodily injury" or "property damage" to a third person or organization. Tort liability means a liability that would be imposed by law in the absence of any contract or agreement.

ISO Form CG 00 01 12 04.

In 2004, ISO offered an endorsement to amend the insured contract definition, adding the following language after the phrase, "to a third person or organization": "provided the 'bodily injury' or 'property damage' is caused, in whole or in part, by you or by those acting your behalf." ISO Form CG 24 26 07 04. In both instances, an insured contract is defined as an underlying agreement where the insured agrees to indemnify an indemnitee for a third party's non-contractual bodily injury or property damage claims against the indemnitee.

For example, a subcontractor may agree to indemnify a contractor against all claims arising out of the subcontractor's performance of its contract. The subcontractor in a typical situation will have CGL coverage for insured contracts. After completion of a project, the owner may sue the contractor for property damage caused, in part, by the subcontractor's negligence. Assuming that the property damage is otherwise a covered occurrence (and not otherwise excluded) under the subcontractor's insurance policy, both the subcontractor and the contractor may be able to assert claims for coverage against the subcontractor's insurer. In such situations, as noted above, parties and even courts may disagree on how to interpret the insured contract exception, including how to determine what constitutes an insured contract and tort liability.

### Is the Underlying Contract An Insured Contract?

To determine whether the underlying agreement is an insured contract, courts should look to the language of the agreement and not the pending claims against the indemnitee. In other words, an insured contract exists if a policyholder agrees in an underlying contract to indemnify another party for its non-contractual liability to third parties, regardless of whether a third party sues an indemnitee for tort liability. *See, e.g., Leaf River Cellulose, LLC v. Mid-Continent Cas. Co.*, No. 2:11-CV-54, 2012 U.S. Dist. LEXIS 73103, *22-23 (SD Miss. May 25, 2012) (determining whether an "insured contract" exists via the language of the underlying agreement); *Lubrizol Corp. v. Nat'l Union Fire Ins. Co.*, 200 Fed. Appx. 555, 562 (6th Cir. 2006) (holding that courts must look to the indemnity agreement to determine whether the insured is obligated to assume another's tort liabilities).

In *Leaf River*, the insurer argued that the court should only look to the underlying claims against the indemnitee to determine whether the insured contract exception applied under the contractual liability exclusion. *Leaf River* at *22. The insurer argued that because the bodily injury to the third party was not caused in whole or part by its insured, the indemnification provision could not constitute an insured contract. *Id.* The court disagreed, stating that the "operative phrase" in the insured contract exception is ambiguous and must be interpreted in favor of the insured "because it could either describe the terms of the indemnity agreement or the particular injury at

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**Paul A. Rose**, a member of this newsletter's Board of Editors, and **Bridget A. Franklin** are Partners at Brouse McDowell, Akron, OH.

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issue in any case to which the policy is applied." *Id.* at *23. Accordingly, the court held that if the insured agrees to indemnify another for its tort liability, then such an indemnification provision is an insured contract notwithstanding the underlying third-party claims against the indemnitee. *Id.*; *see also Legge Assocs. v. Dayton Power & Light Co.*, No. 95-4043, 1997 U.S. App. LEXIS 8702, *19 (6th Cir. Apr. 22, 1997) ("Under the policy, once a contract is deemed an 'insured contract,' it is covered.").

Some courts, however, do not agree with this approach and, instead, look to the underlying claims against the indemnitee to determine whether the damages stemming from an insured contract are covered under the policy. *See, e.g., KBS, Inc. v. Great Am. Ins. Co. of N.Y.*, No. 3:04cv730, 2006 U.S. Dist. LEXIS 88520, *27-28 (E.D.Va. Dec. 7, 2006) (holding that if the underlying third-party claims against the indemnitee do not include "tort liability" claims, "then there is no insured contract status"); *Ewing Constr. Co. v. Amerisure Ins. Co.*, 814 F. Supp. 2d 739, 749 (S.D.Tex. 2011) (holding that the exception is only triggered if the underlying complaint alleges a tort cause of action); *Maxim Indem. Co. v. Jimenez*, 318 Ga. App. 669, 674 (2012) (noting that the exclusion is inapplicable where the underlying claim is not predicated on tort liability).

Further, a minority of courts hold that if an indemnity agreement is void or unenforceable under state law that prohibits one party from assuming liability for another party's negligence, then there may be no coverage for an insured contract. As set forth by one court, if "an anti-indemnification statute prohibits an indemnitee" from "seeking indemnification for its own negligence, it cannot achieve the same result by requiring its indemnitor to procure insurance for that unenforceable indemnity obligation." *True Oil Co. v. Mid-Continent Cas. Co.*, No. 02-CV-1024, 2005 U.S. Dist. LEXIS 48477, *79 (D.Wy. Feb. 8, 2005); *see also Certain London Mkt. Ins. Co. v. Pa. Nat'l Mut. Cas. Ins. Co.*, 106 Fed. Appx. 884, 886 (5th Cir. 2004) (holding that there is no valid basis for tort liability where an anti-indemnification statute exists).

Other courts, however, hold that because the policy does not specifically limit "insured contracts" to enforceable indemnity agreements, insurers cannot rely on anti-indemnity statutes as a basis to deny coverage. *See, e.g., Gilbane Bldg. Co. v. Empire Steel Erectors, L.P.*, No. H-08-1717, 2010 U.S. Dist. LEXIS 121808, *15 (SD Tex. Nov. 16, 2010) (holding that the issue of enforceability is irrelevant with respect to whether there is coverage for the indemnification agreement); *Martin County Coal Corp. v. Universal Underwriters Ins. Servs.*, No. 08-93, 2010 U.S. Dist. LEXIS 158, *13 (E.D.Ky. Jan. 4, 2010) (same). Notably, and no doubt in response to these and similar holdings, ISO modified the insured contract definition in 2013 to include the following language: "However, such part of a contract or agreement shall only be considered an 'insured contract' to the extent your assumption of the tort liability is permitted by law." ISO Form CG 24 26 04 13.

### The Meaning of 'Tort Liability'

An indemnification contract will only be covered as an insured contract if the policyholder assumes the "tort liability" of the indemnitee. Although the definition of "tort liability" is a murky area for courts, the definition in the policy is actually broader than "tort liability" as commonly understood in the legal community. For instance, the policy may state that "[t]ort liability means a *liability* that would be imposed by law in the absence of any contract or agreement." ISO form CG 00 01 12 04. (emphasis added). "Liability" is not defined in the policy and is generally construed broadly by courts. *See, e.g., Providence Journal Co. v. Travelers Indem. Co.*, 938 F. Supp. 1066, 1078 (D.R.I. 1996) ("[L]iability is a broad and expansive concept"); Black's Law Dictionary (10th ed. 2014) (defining liability as "[t]he quality, state, or condition of being legally obligated or accountable; legal responsibility to another or to society, enforceable by civil remedy or criminal punishment; A financial or pecuniary obligation in a specified amount.").

Under this definition, "tort liability" should include any non-contractual liability, including tort, statutory, and any other non-contractual liability. *See, e.g., Gibson Assocs. v. Home Ins. Co.*, 966 F. Supp. 468, 479 fn4 (ND Tex. 1997) (noting that constitutional takings claims arguably fall within the broad definition of "tort liability" under the policy). However, some courts, contrary to the policy language, very narrowly hold that "tort liability" only applies to the assumption of the indemnitee's negligence liability to a third party. *See Lieffort v. Dakota, Minn. & E.R.R. Co.*, 702 F.3d 1055, 1059 (8th Cir. 2013) ("To establish the existence of an insured contract under the terms of the … policy, there must be an obligation to indemnify a party against its own negligence."); *see also Hankins v. Pekin Ins. Co.,* 305 Ill. App. 3d 1088, 1093 (1999) (stating that an "insured contract" is where one party assumes another party's negligence). In addition to providing a narrower definition for "tort liability" than the policy language allows, such courts' limiting "tort liability" to negligence claims is problematic for another reason — as discussed above, some states prohibit one party from assuming liability for another party's negligence. *See True Oil*, 2005 U.S. Dist. LEXIS at *79. Further, the 2013 amendment to the definition of insured contract limits an insurer's liability to enforceable indemnity agreements. ISO Form CG 24 26 04 13. In such states, if "tort liability" is limited to the assumption of only another party's negligence liability, the

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exception may in effect be written out of the policy entirely.

Other courts, while refusing to limit the definition of "tort liability" to negligence alone, hold that only certain "tort" liabilities may be covered under the policy, *e.g.*, negligence or vicarious liability. *See, e.g., United Rentals, Inc. v. Mid-Continent Cas. Co.*, 843 F. Supp. 2d 1309, 1314 (S.D.Fla. 2012) (limiting "tort liability" to vicarious liability). These courts take a more expansive view but still improperly limit the definition of "tort liability" to one that is narrower than the language of the contract. The policy itself is clear — if, in the underlying agreement, the policyholder agrees to indemnify an indemnitee for the indemnitee's non-contractual liability to third parties, the indemnifying parties have an insured contract.

### Indemnitee's Direct Action Against Insurer

Under certain policies, an "additional insured" may include "[a]ny person or organization … whom the named insured has agreed by written 'insured contract' to designate as an additional insured … ." *United Rentals* at 1312 fn. 5; *Leaf River*, 2012 U.S. Dist. LEXIS 73103 at *31. In such instances, courts allow the indemnitee to assert coverage claims directly against the policyholder's insurers. *See Leaf River* at *31. However, even when an indemnitee is not listed as an additional insured, some courts have held that an indemnitee stands in the shoes of the insured and can bring a direct action against the insurance company. *Marlin v. Wetzel County Bd. of Educ.*, 569 S.E.2d 462, 468-469 (W.Va. 2002) (holding that indemnitee can directly assert coverage under indemnitor's contract); *Krieger v. Wilson Corp.*, 139 N.M. 274, 287 (2005) (holding that the indemnitee can bring a direct action against the indemnitor's insurance company because "as a potential indemnitee under an insured contract, [the indemnitee] can reasonably claim to stand in the shoes of [the] insured."); *Consolidated Coal Co. v. Boston Old Colony Ins. Co.*, 508 S.E.2d 102, paragraph seven of the syllabus (W.Va. 1998) (holding that "when a party has an "insured contract," that party stands in the same shoes as the insured for coverage purposes").

In *Marlin*, the owner and insured contractor entered into an indemnity agreement whereby the insured agreed to indemnify the owner from any claims arising from the insured's performance of the contract. *Marlin*, 2012 W.Va. at 218. Subcontractors made claims against the owner and the insured for bodily injury caused by asbestos exposure. *Id*. at 219. The owner demanded, pursuant to the insured contract exception, that the contractor's insurer assume its defense and provide indemnity coverage for the asbestos injuries. *Id*. The insurer refused to honor any coverage responsibilities to the owner, asserting that it was only required to provide defense and indemnity coverage to its insured. *Id*. The court disagreed with the insurer, holding that as a result of the insured contract, the owner "stands in the same shoes" as the insured "for coverage purposes" and "may directly seek coverage under the policy." *Id*. at 222. In so holding, the court determined that the "policy insured any sums which [the contractor] was 'legally required to pay as damages because of bodily injury or property damage,' including any liability … assumed by [the contractor] under the indemnification provision of the construction contract." *Id*. Because the indemnity agreement shifted responsibility for the third party tort claims from the owner to the contractor, the liability was also shifted to the insurer. *Id*.

However, other courts disagree, holding that an indemnitee has no standing to sue a policyholder's insurance company directly. *See, e.g., Carye v. Granite State Ins. Co.*, No. 281-5-08, 2008 Vt. Super. LEXIS 56, *8-10 (Sup. Ct. Vt. Oct. 7, 2008) (dismissing indemnitee's complaint against indemnitor's insurance company and criticizing courts allowing direct actions in connection with insured contracts); *Tremco, Inc. v. Manufacturers' Ins. Co.*, 2002 Phila. Ct. Com. Pl. LEXIS 39, *26 (Jun. 27, 2002) (holding that the indemnitee cannot enforce a provision of a contract to which it is not a party).

Many jurisdictions have not yet ruled on whether an indemnitee can assert a direct claim or bring a direct action against the indemnitor's insurer. In other jurisdictions, the guidelines are clear. Accordingly, policyholders and indemnitees should carefully investigate and consider their rights under the applicable law to assert coverage under the indemnitor's policy. To best assure protection, before entering into an indemnification agreement, the indemnitee should consider requiring that the policyholder indemnitor add the indemnitee as an additional insured under the insurance policy.

### Conclusion

Although the application of the "insured contract" exception may be confusing to policyholders and courts alike, parties to an indemnification agreement, including policyholders and non-policyholders, should not shy away from asserting coverage in connection with property damage or bodily injury liability related to insured contracts. All of the confusion among the courts, policyholders, and insurers is an indicator that the "insured contract" policy language may well be ambiguous. In such situations, the insured contract exception should be interpreted in favor of coverage.

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was victim to a data breach that exposed the payment cards and e-mail addresses of nearly 56 million of its customers. In 2015, health insurer Anthem Inc. was attacked by cyber hackers who obtained data such as names, birthdates, Social Security numbers, medical IDs, addresses and income on tens of millions of current and former Anthem customers and employees. The foregoing examples are only a handful of the now-seemingly ubiquitous occurrence of corporate data breaches that leave individuals' private and sensitive information exposed and vulnerable to misuse or exploitation.

A data breach threatens not only to reveal confidential personal or business information, but it also can result in significant legal liability for companies as a result of the litigation that often follows. Sony, for instance, reportedly paid upwards of $8 million to settle claims from employees whose personal information was leaked following the 2014 computer hack. It was even more costly for Target, which reportedly reached a settlement following its 2013 data breach wherein it agreed to reimburse thousands of financial institutions as much as $67 million in costs associated from that cyber-breach. The lawsuits that follow a data breach often add insult to injury: After a company weathers the immediate negative media attention and financial repercussions that come with a high-profile data breach, it then must endure costly legal battles that seek remuneration on behalf of those directly affected by the taking of private information.

As a result, the need to guard against cyber-attacks is paramount. According to a recent *Wall Street Journal* report, J.P. Morgan Chase & Co., for example, expects to boost its cyber-security budget to about $500 million in 2016, a number nearly double what it spent in 2015. Importantly, though, merely increasing cyber-security expenditures to minimize the risk of a cyber-attack is not enough. This is why companies are now beginning to purchase cyber insurance policies, so that businesses are better able to mitigate potential liability risk in the event a cyber-attack is successful.

**Chet A. Kronenberg**, a member of this newsletter's Board of Editors, is a litigation partner in the Los Angeles office of Simpson Thacher & Bartlett LLP. **Tyler Z. Bernstein** is a litigation associate in the same office.

### Insurance Coverage Lawsuits Stemming from Cyber-Attacks

To date, there have only been a handful of insurance coverage cases stemming from a cyber-attack. Below is a discussion of four recent cases.

***1. Zurich American Ins. Co. v. Sony Corp. of America, et al.***

*Zurich American Insurance Co. v. Sony Corp. of America*, Index No. 651982/2011 (N.Y. Sup. Ct., filed July 20, 2011), was an insurance coverage dispute concerning whether the theft of electronic data was covered under a commercial general liability policy. The coverage dispute arose after computer hackers obtained unauthorized access to, and stole personal identification and financial information of, users from Sony's PlayStation network. As a result of that hack, users of Sony's PlayStation network sued various Sony entities in 58 class action complaints in the United States and Canada. The class action complaints generally alleged that the Sony customers were harmed because of: 1) the unauthorized access to and alleged theft of their personal identification and financial information maintained on Sony's PlayStation severs; and 2) Sony's delay in notifying affected customers of the cyber-attack and the accessing of their personal and financial information. In response, Sony tendered defense of the class action complaints to Zurich American Insurance Company and Zurich Insurance Company Ltd. (collectively, "Zurich") seeking defense coverage and indemnification.

Zurich filed a complaint against Sony seeking a declaration that it was not obligated to defend or indemnify Sony. Alternatively, the complaint sought a declaration as to the proper allocation or apportionment of any defense or indemnity obligations as between Sony, Zurich and certain of Sony's other insurers to which Sony also tendered defense of the class action complaints. Zurich primarily argued that the claims in the class action complaints arising out of the cyber-attack did not constitute claims for "personal and advertising injury," which the Zurich policy defined as an injury, among other things, arising out of the "oral or written publication in any manner of the material that violates a person's right to privacy."

In its bench ruling on the parties' cross motions for summary judgment, the trial court agreed with Zurich. While the court recognized that the Sony users' personal information had been technically "published" under the "personal and advertising injury" provision, it interpreted that provision to require that the policyholder itself (*i.e.*, Sony) be the actor who publishes the information. The court ruled that that did not happen, as the "publication" of Sony users' data was done by the hackers who stole the information — not Sony. Thus, in the court's opinion, because the applicable provision of the Zurich policy did not provide coverage for the intentional acts of third parties, the court granted Zurich's motion and held that Zurich had no duty to defend or indemnify Sony for the class action complaints.

Sony appealed the trial court's ruling to the New York Appellate Court. Two months after the Appellate Court heard oral argument on Sony's appeal, the parties settled the dispute by stipulating to a withdrawal of Sony's appeal and dismissal of the case with prejudice.

***2. Recall Total Information Mgmt., Inc. v. Federal Ins. Co.***

*Recall Total Information Management, Inc. v. Federal Insurance Co.*, 147 Conn. App. 450 (2014), aff'd, 317 Conn. 46 (2015), involved an insurance dispute that arose when Recall Total Information Management,

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Inc. ("Recall"), a record storage company, and Executive Logistics, Inc. ("Ex Log"), Recall's transportation subcontractor, lost in transit data tapes containing employment-related data for 500,000 Internal Business Machines ("IBM") employees. The information consisted of birthdates, Social Security numbers and contact information. IBM immediately took steps to prevent the dissemination of this personal information, including notifying potentially affected employees and providing one year of credit monitoring for those who could be affected. IBM claimed a total of more than $6 million in expenses for the mitigation measures it took and entered into a negotiated settlement with Recall for the full amount of the loss.

Thereafter, Recall sought indemnification from Ex Log. Under Recall's contract with Ex Log, the latter was required to maintain various insurance policies, including a $2 million commercial general liability policy and a $5 million umbrella liability policy. Following Recall's request for indemnification, Ex Log sought coverage from its insurers, but the insurers denied coverage. Following that denial of coverage, Recall and Ex Log entered into a settlement agreement whereby Ex Log, among other things, assigned all of its rights under the insurance policy to Recall.

Shortly thereafter, Recall sued the insurers for breach of contract. The insurers moved for summary judgment, arguing that: 1) they had no duty to defend with respect to IBM's demand and the negotiations that followed; and 2) Recall's loss was not covered by the policy. The trial court granted summary judgment for the insurers, finding that the insurers had no duty to defend Recall in its settlement negotiations with IBM and that the data loss was not covered under the policy.

Recall appealed. The appellate court first affirmed that the insurers had no duty to defend Recall with respect to the negotiations that followed IBM's demand against Recall. The court held that the term "suit" under the policy (for purposes of establishing when a duty to defend is owed) was not meant to encompass negotiations following a demand.

The appellate court then addressed Recall's argument that the trial court misinterpreted the personal injury provision in the policy. The policy at issue provided coverage for "personal injury," which the policy defined as "injury, other than bodily injury, property damage or advertising injury, caused by an offense of … electronic, oral, written or other publication of material that … violates a person's right to privacy." Recall maintained that this language covered the cost of notifying the affected employees following the loss of the data tapes because the confidential information stored on those tapes, including Social Security information and other private data, had been published to the thief and/or other persons unknown. The Appellate Court disagreed, disputing that the information on the tapes had been published. According to the Appellate Court, "the dispositive issue [was] not the loss of the physical tapes themselves; rather, it [wa]s whether the information in them ha[d] been published." The Appellate Court held that Recall had failed to cite any evidence that the information on the tapes was ever accessed by anyone. Accordingly, the Appellate Court found that the settlement Recall reached with IBM was not covered under the policy's personal injury policy, and affirmed summary judgment for the insurers.

***3. Travelers v. Federal Recovery Services, Inc.***

While Sony and Recall Total involved the application of a traditional commercial general liability policy to a data breach, the case of *Travelers v. Federal Recovery Services, Inc.*, No. 14 Civ. 170 (D. Utah 2015), generated a coverage ruling interpreting traditional insurance law concepts contained in a cyber insurance policy.

In *Travelers*, the insured, Federal Recovery Services, Inc. ("FRS"), provided processing, storage, transmission and other handling of electronic data for its customers. One of FRS's clients was Global Fitness Holdings, LLC ("Global Fitness"), which contracted with FRS to have the latter process Global Fitness's gym members' payments under a Servicing Retail Installment Agreement ("Servicing Agreement"). The Servicing Agreement provided, in part, that FRA would retain the only copy of the member accounts data on behalf of Global Fitness. In connection with a corporate transaction with another gym, Global Fitness agreed to transfer all of its member accounts data to the other gym. In order to so, though, Global Fitness needed FRA to return the original member data to Global Fitness. After several unsuccessful efforts to obtain all the member account data from FRA, Global Fitness filed suit, alleging, *inter alia*, that FRA wrongfully withheld the member data unless and until Global Fitness provided significant compensation beyond what was provided for in the Servicing Agreement.

FRA tendered defense of the lawsuit to Travelers Property Casualty Company of America ("Travelers"), which had issued a CyberFirst insurance policy to FRA. Included in the policy was a Technology Errors and Omissions Liability form, which stated that Travelers "will pay those sums that the insured must pay as 'damages' … caused by an 'errors and omissions wrongful act.'" The policy defined "errors and omissions wrongful act" as meaning "any error, omission or negligent act." Prior to accepting FRA's tender of defense, Travelers filed a declaratory relief action seeking a determination that it did not owe FRA a duty to defend. When Travelers later accepted FRA's tender of defense, it did so under a full and complete reservation of rights. FRA then moved for partial summary judgment seeking a determination that Travelers did owe FRA a duty to defend.

Travelers argued that the Global Fitness action did not trigger its duty to defend FRA because the allegations against FRA did not allege damages arising from any error,

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# Case Notes

### *Cumis* Counsel on the Hook For Unreasonable Fees

*Cumis* counsel is an attorney engaged directly by a defendant when there is liability insurance potentially covering the claim, but there is a conflict of interest between the insurance company and the insured defendant. The moniker for this independent counsel comes from the well-known case of *San Diego Navy Federal Credit Union v. Cumis Insurance Society, Inc.*, 162 Cal. App. 3d 358, 208 Cal. Rptr. 494 (1984). The most common conflict requiring appointment of *Cumis* counsel is when the insurer denies or refuses to defend all or part of a claim but pays for some part of the defense under a reservation of rights. In such cases, an insurer may be ordered by a court to provide (and pay for) independent defense counsel under a reservation of rights.

In *Buss v. Superior Court*, 16 Cal. 4th 35, 49 (1997), the Supreme Court of California held the insured would be unjustly enriched if not ultimately required to pay the cost of defending any claims for which it had not purchased defense or indemnity insurance. Accordingly, the *Buss* court held the insurer may seek reimbursement from the insured for those defense costs attributable solely to uncovered claims. The court was not asked in *Buss* to consider the scenario wherein a court order requires the insurer to pay "reasonable and necessary defense costs" but expressly preserves the insurers right to recover payments for "unreasonable and unnecessary" charges by *Cumis* counsel, and the insurer alleges *Cumis* counsel padded bills with excessive, unreasonable and unnecessary charges. That multi-faceted question is addressed in the recent case of *Hartford Casualty Insurance Company v. J.R. Marketing, L.L.C.*, California Supreme Court case no. 5211645.

In this recently decided case, Hartford contended it should be able to recoup the overbilled amounts directly from *Cumis* counsel. The Cumis counsel, Squire Sanders (US) LLP argued that if Hartford had any rights at all to recover purportedly overbilled amounts, such rights run solely against Hartford's insured, J.R. Marketing. Thereafter, if Hartford was successful in getting a judgment against J.R. Marketing, then the latter might have a right of indemnity against Squire Sanders.

The facts underlying the dispute are as follows. In 2005, a lawsuit was filed against J.R. Marketing and others. The defense of this lawsuit was submitted to Hartford, which denied any duty to defend or indemnify, but subsequently agreed to defend subject to a reservation of rights. A coverage action ensued, resulting in a finding that Hartford had a duty to defend and also provided that because of the reservation of rights, Hartford must fund *Cumis* counsel for J.R. Marketing. The latter selected Squire Sander as *Cumis* counsel. The order from the trial court in the coverage matter included a statement that Squire Sanders bills must be reasonable and necessary, and to the extent Hartford seeks to challenge any fees or costs as unreasonable or unnecessary, it could do so by way of reimbursement after resolution of the underlying action.

The underlying action was resolved in October 2009, and the coverage action, stayed during its pendency, resumed. Hartford filed a cross-complaint in the coverage action alleging it was entitled to recoup $13.5 million paid to Squire Sanders. The latter was a cross-defendant, and argued that Hartford could assert no legal or equitable claim against *Cumis* counsel or any other non-insured because Hartford's right to reimbursement depends on the contractual relationship between Hartford and J.R. Marketing. The trial court in the coverage matter agreed with Squire Sanders and ruled that Hartford's right to reimbursement, if any, was limited to J.R. Marketing.

We conclude this discussion in next month's issue. — **Jessica F. Pardi**, Morris, Manning & Martin

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omission or negligent act. The District Court agreed. In denying FRA's motion for partial summary judgment, the court found that Global Fitness's allegations against FRA did not include any claims of error, omission or negligence. Rather, Global Fitness alleged that FRA knowingly withheld the member accounts data and refused to turn it over to Global Fitness until Global Fitness met certain compensation demands. In the court's view, these allegations sounded in "knowledge, willfulness, and malice," not negligence. Consequently, the court held that Travelers had no duty to defend FRA against Global Fitness's allegations.

***4. Columbia Casualty Co. v. Cottage Health System***

Like the *Travelers* case, *Columbia Casualty Co. v. Cottage Health System*, No. 15 Civ. 3432 (C.D. Cal. 2015), was an insurance coverage dispute under a cyber liability insurance policy. But, *Columbia Casualty*, unlike *Travelers*, involved a true electronic data breach incident.

This matter arose out of a data breach that resulted in the release of electronic private health care patient information for over 32,000 individuals stored on network servers owned, maintained and utilized by Cottage Health System ("Cottage"). Following that data breach, Cottage faced a class action lawsuit in which plaintiffs asserted claims against Cottage based on its alleged breach of California's Confidentiality of Medical Information Act. In addition, the California Department of Justice ("DOJ") opened an investigation following

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the breach to determine whether Cottage complied with its obligations under HIPAA and related state and federal laws. The class action complaint alleged that the breach occurred because Cottage and one of its service vendors stored medical records on a system fully accessible to the internet, but without any encryption or security safeguards to keep the information private. A settlement of $4.125 million was reached in the underlying class action.

Columbia Casualty Co. ("Columbia"), as Cottage's insurer, agreed to fund the settlement, subject to a complete reservation of rights. Columbia had issued to Cottage a "NetProtect 360" claims-made liability policy for the policy period covered by the data breach and resulting class action ("Policy"). The Policy provided $10 million in coverage for damages arising out of privacy injury claims (such as the class action lawsuit) and privacy regulation proceedings (such as the DOJ investigation). Significantly, the Policy contained a "Failure to Follow Minimum Required Practices" exclusion, which relieved Columbia from having to cover any loss based upon the failure of its insured to continuously implement the risk controls procedures identified in the insured's insurance application. In Cottage's application, it made several representations in the "Risk Control Self Assessment" questionnaire attesting to the security settings, configurations and oversight Cottage provided to its system network.

Subsequent to funding the settlement, Columbia filed a declaratory judgment action against Cottage seeking a declaration that it was not obligated to provide Cottage with coverage and was entitled to reimbursement of all costs arising out of the settlement of the class action proceeding. Based upon the allegations in the complaint, there did not appear to be any dispute that the data breaches, resulting lawsuit and DOJ investigation implicated the Policy. Columbia thus sought a declaration that it had no duty to defend on two main grounds: the minimum required practices exclusion and misrepresentation defense. As to the minimum required practices exclusion, Columbia principally argued that it was entitled to disclaim coverage because Cottage failed to continuously implement the risk management protocols identified in its insurance application. Specifically, Columbia claimed that the privacy claims resulting from the class action were excluded from coverage because Cottage: 1) permitted anonymous user access, which made electronic personal information publicly available via a simple Google search; 2) failed to replace factory default settings to ensure that information security systems were securely configured; and 3) failed to regularly check and maintain security patches on its system.

Relatedly, Columbia cited to the Policy's provision that precluded coverage if the Policy's application contained any material misrepresentations or omissions. In particular, the application required Cottage to warrant that it maintained all risk controls identified in its application. Columbia claimed that the data breach at issue was caused by Cottage's failure to maintain the application's risk controls, by, among other things, failing to replace factory default settings to ensure that its information security systems were securely configured. Columbia, therefore, alleged that Cottage's application contained material misrepresentations and/or omissions, such that Columbia was not obligated to defend or indemnify Cottage under the Policy.

Columbia's lawsuit against Cottage did not progress far. On June 18, 2015, after Columbia filed suit, Cottage moved to dismiss on the ground that Columbia failed to comply with the Policy's mandatory alternative dispute resolution requirement that called for the parties to mediate any disputes prior to commencing litigation. On July 17, 2015, the district court granted Cottage's motion to dismiss and dismissed Columbia's complaint without prejudice so that the parties may pursue the mediation called for by the Policy.

### Important Takeaways

As the foregoing makes clear, litigation involving cyber- or technological-based incidents and the role of insurance coverage in this burgeoning practice area are increasing. While there have been relatively few substantive decisions to date analyzing the scope and effect of pure cyber liability insurance policies, the cases thus far offer important insights for participants in the cyber liability insurance arena. For one, despite the uniquely technological fact patterns, cyber insurance disputes will inevitably rely upon and drawn heavily from traditional insurance law principles.

As *Sony*, *Travelers* and *Recall Total* illustrate, the outcome of cyber insurance disputes will often turn on the interpretative principles and case law established in the non-cyber insurance law context, such as jurisprudence involving errors and omissions or commercial liability precedents. In addition, as demonstrated in the *Columbia* action, negotiating the best possible cyber policy language is crucial. Because cyber liability issues do not fit neatly within traditional liability policy language, it is important for insurers to understand the unique potential risk profile associated with technological or cyber issues and draft language that helps minimize the insurer's possible exposure.

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