NEW JERSEY EXPANDS TRADITIONAL NOTIONS OF PHYSICAL LOSS OR DAMAGE

By: Michael McLaughlin, Esq., Butler Pappas Weihmuller Katz Craig LLP

New Jersey courts continue to expand traditional notions of physical loss or damage in a recent decision of the New Jersey Federal District Court, Gregory Packaging, Inc. v. Travelers Prop. Cas. Co. of America, Civ. No. 2:12–cv–04418 WHW, 2014 WL 6675934 (D.N.J. Nov. 25, 2014) (J. Walls). The court held that a building suffered physical loss or damage after an ammonia release, even though there was no structural change or alteration to the property that required some degree of repair or replacement.

The Gregory Packaging, Inc. case arose out of the accidental release of ammonia during the installation of a refrigeration system in a manufacturing and packaging plant in Newnan, Georgia. The ammonia burned a refrigerator installer upon release, but there were no tangible alterations or change to any of the property therein. The plant was evacuated after the release because of unsafe conditions, and government authorities arrived at the scene. Gregory Packaging hired a remediation company to dissipate the ammonia to reach a safe level for occupancy. It took approximately five (5) days for the ammonia to be dissipated to a safe level.

The plant was insured under a commercial property insurance policy issued by Travelers that provided coverage for “direct physical loss of or damage to Covered Property caused by or resulting from a covered

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Dear Property Insurance Law Committee Members:

It is hard to believe I am halfway done with my Chairmanship. Much has been accomplished, yet so much still needs to be done.

As predicted, Jay Levin did a bang-up job on the Annual Survey. Not only was it submitted on time as required by the ABA, but it was one of the best Articles ever put together by this Committee. We just received word that it is in the process of being proofread and the expectation is that it will go to print sometime next month. Be on the lookout for this great update put together by your colleagues.

Earlier this month, a group including myself, as well as our Past Chairs Timothy Penn and Kellyn Muller, Chair-Elect-Designee Christina Phillips and Vice-Chairs Sean McAloon, Stacey Stracener, Steve Clancy and Jonathan MacBrade attended a strategic planning session at the ABA Mid-Year meeting in Houston Texas. This session provided a good opportunity for us to kick the proverbial tires on our Committee, and see what we could do to make it even better for our Members. As a direct result of this session, which was facilitated by Alan Rutkin and Mike Colliflower, we came up with three (3) initiatives that we would like to implement for the PILC. They are: (1) to provide Case Law Updates to our Members on a real time basis; (2) to create a Property 101 Webinar; and (3) to prepare a Small Book/Brochure on Disaster Advice as part of a Public Service Project. Having lived through and been directly impacted by Super Storm Sandy, I can state with certainty that the general public has little to no idea what to do in the event of a property loss. Preparing a Brochure to be handed out to those impacted by a casualty, providing simple advice, and giving answers to some frequently asked questions is something I believe we are morally obligated to do as Property attorneys. If anyone interested in helping with any of the above initiatives, we are always looking for volunteers.

The preparations for our Annual Meeting are almost finished, and the brochure should go out any day. From Claim to Verdict: Litigating the Complex Commercial Property Insurance Claim is going to be a great program, sponsored by many of the firms that have historically and traditionally supported our Committee. May will be a great time of year to be in San Antonio, and the JW Marriott is up to the task of playing the role of gracious host. We hope to see as many of you there as possible.

I look forward to continuing the great traditions of leadership this Committee has experienced in its years as a General TIPS Committee in my final months as Chair. Because of all of you, and our great succession planning, we will continue to excel and do great things once Heidi takes over in August. Until then, I remain your devoted Leader.

Thank you.

Johnathan Lerner
Chair, Property Insurance Law Committee
We are pleased to advise the Committee that preparations are almost complete for the 2015 Spring Meeting, which will be held at the luxurious JW Marriott Hill Country Resort & Spa near San Antonio, Texas from May 7th through May 9th. Ranked as one of the top 500 hotels in the world by Travel + Leisure Magazine, the resort features wonderful restaurants, a signature spa, luxurious guestrooms and suites, and is home to the 36-hole TPC San Antonio, featuring two championship courses on the PGA Tour. The resort also offers family activities including a water park, and organized outdoor children’s activities. A phenomenal discounted rate of $229.00 per night as well as a reduced $10.00 resort fee is being offered to Meeting attendees.

The 2015 Meeting follows the progression of a complex commercial property insurance claim involving a suspicious fire from submission of the claim through litigation and appeal. We are in the process of finalizing the fact pattern, which is replete with most every conceivable issue that could be encountered by property insurance lawyers in handling a complex commercial fire claim. The fact pattern will be provided to all Meeting participants and will serve as the roadmap for our speakers in formulating their presentations, which will range from topics including claim investigation, adjustment, coverage determination, ensuing litigation and ethical considerations. We are proud to have gathered a well rounded group of presenters from both the policyholder and defense bars, as well as accounting and cause and origin experts. We are also thrilled to have esteemed Judges, Hon. John F. Lakin, 12th Circuit Court of Florida, Hon. James E. Graves Jr., Fifth Circuit U.S. Court of Appeals and Hon. David R. Strawbridge, U.S.D.C., E.D.Pa., presenting on three of our panels.

All that is left to do in preparing for the Meeting is to select one of the many wonderful restaurants or dinner cruises, located on San Antonio’s River Walk, for our group dinner on the evening of May 7th, which will be done shortly. We are also in the process of finalizing Meeting sponsors. We ask that all of our presenters submit their written materials for the meeting no later than March 15th. We encourage all of our members to mark their calendars now and begin making their reservations, as this is going to be a great Meeting that you will not want to miss.

Thank you.

Sean McAloon and Stacey Stracener
Co-Chairs, Property Insurance Law Committee
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DOWNPOUR OR DOWNFALL: ACC CLAUSES ARE RAINING ON COVERAGE

By: Amy Bach, Esq. and Dan Wade, Esq., The authors are the Executive Director and Staff Attorney for United Policyholders, uphelp.org

INTRODUCTION

Property damage is almost always caused by more than one factor. Water from one or more sources, combined with faulty workmanship in foundation or framing installation or materials, improper grading or drainage, deferred maintenance, and a litany of other factors can contribute, either concurrently or sequentially to damage. The purpose of insurance is to provide indemnity in case of loss. Judicial acceptance and enforcement of anti-concurrent causation clauses (“ACC”) in property insurance policies fundamentally undermines that purpose and complicates the analysis of coverage to the point of absurdity. There is rarely, if ever, one cause of damage, but always one goal: repair and recover. Strict ACC clause enforcement thwarts that goal.

ACC clauses also increase the pressure on hired third-party experts to artificially and strategically segment and attribute damage. Forensic and technical experts for hire, particularly those retained routinely by insurers, are vulnerable to being unduly influenced in reaching their findings and/or oriented toward attributing damage to excluded perils.

In a widely publicized ruling in coordinated Superstorm Sandy litigation on November 7, 2014, Eastern District of New York Magistrate Judge Gary Brown condemned “[r]eprehensible gamesmanship by a professional engineering company that unjustly frustrated efforts by two homeowners to get fair consideration of [their] claims. Worse yet, evidence suggests that these unprincipled practices may be widespread.” The altered engineering reports were used by insurers to classify damage as having been caused by an excluded peril. See In Re Hurricane Sandy Cases.¹

The enforcement of the ACC not only frustrates the purpose of insurance for property damage but has undermined the public’s confidence in the value of paying for discretionary (as opposed to mandatory) insurance products.

In New York and New Jersey, victims of Superstorm Sandy on average received a paltry $16,000 in insurance payments for losses that averaged $103,000. In large measure due to ACC clauses, coverage disputes arose over whether the damage had been cause by wind-driven rain, storm surge, both, or earth movement. On the heels of Judge Brown’s ruling, homeowners are doubly infuriated by insurers’ failure to fund their recovery. “I’ve been with (Insurer X) for 40 years, never filed a claim, then when the worst thing that ever happened to our family wiped out our home, they’re hiding behind legalese and not paying. What a waste of money that was.” is the common refrain.

With the ACC ruling (“CDBG”) seas, Community Development Block Grants have emerged as an alternative source of disaster rebuilding financing, as well as yet another source of disappointment. These grants were never intended to be a substitute for private insurance on individual homes. CDBG is intended to provide flexible grants to help cities, counties and states recover from Presidentially declared disasters, especially in low-income areas.² Eligibility and paperwork requirements for CDBG grants to individual Sandy victim households have been labyrinthine and delays have been notorious. See “Sandy victims rally against New York Rising” in Long Island Newsday.³

Judges need to recognize that allowing insurers to strictly enforce ACC clauses in contracts of adhesion and, thereby, avoid funding disaster recovery may be good for shareholders but not for our economy, or long term, the business of insurance.

THE ACC

A typical ACC reads:

“We do not cover loss to any property resulting directly or indirectly from any of the following…flooding, including storm surge and most water damage including sewer backup and overflow, earth movement, volcanic eruption…such loss or damage is excluded regardless of any other cause or event that contributes concurrently or in any sequence to the loss.”

Some have called it, a “tongue twister.” But to people who need their insurance to pay to replace a

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POTENTIALLY FRAUDULENT INSURANCE COMPANY PRACTICES ARE EXPOSED IN SUPERSTORM SANDY LITIGATION

By: Jay M. Levin and Jennifer D. Katz

We recently marked the two year anniversary of Superstorm Sandy. With that anniversary came an influx of litigation in response to insurance companies denying or overly limiting coverage. That litigation recently revealed highly questionable practices within the industry.

Most striking was the opinion in Raimey v. Wright National Flood Insurance Company, Case No. 1:14-MC-00041-CKP-GRB-RER (E.D.N.Y. Nov. 7, 2014). There, United States Magistrate Judge Gary R. Brown exposed “reprehensible [and possibly widespread] gamesmanship” by a professional engineering firm, U.S. Forensic, retained by Wright National Flood Insurance to investigate damage to the Raimey home following Superstorm Sandy. A U.S. Forensic engineer visited and photographed the Raimey home following Sandy and prepared a report detailing his conclusion that the home had been damaged beyond repair. The report specifically noted that the structural damage was the result of “hydrodynamic forces associated with the flood event of October 29, 2012” and that repair was “not economically viable.”

That report, however, was subsequently re-written under the guise of “peer review” by another U.S. Forensic engineer who relied solely on photographs. The new report reached the opposite conclusion -- that the home was not structurally damaged by hydrodynamic forces from the flood, and the damages were the result of “long-term” deterioration. The insurance carrier denied coverage based on the latter report, and never produced the earlier report.

The Court found that the insurer’s failure to reveal the existence of the earlier report, let alone the report itself or any drafts and communications concerning the preparation of the reports, was particularly “reprehensible” because the insurer had been “under unequivocal and repeated Court direction to produce all expert reports, photographs, and written communications that contain any description or analysis of the scope of loss or any defenses under the policy.” As a result of this conduct, the Court ordered all defendants in “any” Hurricane Sandy case to provide plaintiffs with copies of “all reports … plus any drafts, redlines, markups, reports, notes, measurements, photographs and written communications related thereto – prepared, collected or taken by any engineer, adjustor or other agent or contractor affiliated with any defendant, relating to the properties and damage at issue in each and every case, whether such documents are in the possession of defendant or any third party.”

This Order was resisted by the insurance companies in motions for reconsideration, which motions were denied in a strongly worded Order on December 8, 2014. The Court will hold another evidentiary hearing to address the fact that the misconduct does not appear to be limited to the Raimey claim.

Pre-existing Damage

A similar practice was alleged in a case involving a different insurance company, Hartford Insurance Company of the Midwest. The Complaint in Dweck v. Hartford Insurance Company of The Midwest, No.: 1:14-cv-06920-ERK-JMA (E.D.N.Y.) (filed on Dec. 3, 2014), alleges that HiRise Engineering inspected Plaintiff’s home after Sandy, and an engineer licensed in New York wrote a report opining that there was extreme damage from the flood. Another engineer at HiRise, who was not licensed in New York, altered the report so it read that the damage was pre-existing and caused by soil consolidation, and then affixed the first engineer’s seal without showing him the report. The first engineer, when confronted with the altered report, disavowed its conclusions and stuck by his original findings. The Complaint goes on to allege breach of contract, mail and wire fraud as predicates for a R.I.C.O. claim, and bad faith, and seeks class certification.

An almost identical Complaint was filed in Shlyonsky v. HiRise Engineering, P.C., No.: 1:14-cv-07136-RJD-MDG (E.D.N.Y.) (filed on Dec. 5, 2014), by three firms, including one of the firms that filed Dweck. The allegations in this case identified Travelers Insurance Company, d/b/a The Standard Fire Insurance Company, as the offending carrier. The Shlyonskys allege that HiRise again altered an engineering report to change the conclusions from flood damage to pre-existing damage without the original engineer’s knowledge or approval. It also seeks class certification and asserts the same claims as in Dweck.

The Raimey case, in particular, has enraged a community still struggling to re-build after Sandy. It
has generated intense interest from New Jersey Senators Robert Menendez and Cory Booker who, on November 14, 2014, jointly wrote to FEMA as the party “ultimately responsible for [the Write Your Own (WYO) insurance companies’] behavior.” The Senators highlighted FEMA’s “unbalanced penalty structure” that punishes WYOs for overpaying on claims which results in “aggressive[]” practices to reduce the payments to policyholders. The Senators characterized the Raimey opinion as the “smoking gun of a pervasive and intentional effort to lowball disaster victims …” and based on “FEMA’s lack of oversight or tacit encouragement of these procedures, WYO insurance providers continue to engage in these highly questionable practices.”

The Senators seek to have FEMA conduct a full investigation into the “pervasiveness” of the concealed report alterations and report to Congress on its findings with a plan for increased “transparency” and consumer protections. They further seek to have WYOs “comply with the New York Court order [Raimey] for New Jersey cases and fully disclose to policyholders each variation of adjuster and engineering reports on the assessment of the policyholder’s damage with relation to the policyholder’s coverage, including an explanation of why an additional report was ordered” as well as sanctions and penalties imposed against wrongdoers.

FEMA responded by committing to reform the claims process and called on the WYO insurers to comply with Judge Brown’s Order. FEMA will now reopen and reconsider some 270 appeals of claim denials and take administrative action to ensure that WYO carriers are penalized equally for under-payment and over-payment on flood claims. FEMA further agreed to appoint an advocate to help policyholders through the Sandy claims and appeals process.

**Lessons Learned**

Lawyers should be aware of these cases. First, lawyers have a duty to conduct a “reasonable inquiry” to ensure that their clients’ discovery disclosure is “complete and correct as of the time it is made.” Fed. R. Civ. Pro. 26(g). Judge Brown concluded that defense counsel violated their obligations by limiting their discovery inquiry to the insurance company’s claim file. They had an obligation to inquire with the engineering firm retained to investigate the loss. Second, policyholder counsel should always demand copies of all inspection reports and damage estimates with respect to the loss prepared for the insurance company, and never assume that the final report actually represents the opinions of the engineers or other professionals who actually inspected the property. Policyholder counsel should conduct thorough discovery of all experts to make certain that there has been no misconduct similar to that in Raimey and, allegedly, in Dweck and Shlyonsky. Expert reports are the cornerstone of all property insurance claims, not just flood claims. As a result, the contents and supporting documentation should be carefully examined.

Federal flood insurance is designed to provide protection not available in the ordinary insurance market. To the extent the cost is not covered by policy premiums, it is funded by the public fisc. For insurers and their agents to commit fraud against policyholders under these policies, for whatever reason, multiplies the economic and emotional damages policyholders suffer from a disaster like Sandy. Given that the insurers have no financial liability for these claims, they should adjust and pay them honestly and promptly. In fact, many insurers do. If, however, any insurers do not, but instead participate in or condone fraud, they should be barred from the program and sanctioned by the appropriate regulatory authorities.

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The definition of the insurance term “actual cash value” (ACV) has resulted in multiple definitions depending upon the applicable jurisdiction. Some courts define it as fair market value, some courts define it as replacement cost value (RCV) less physical depreciation while others apply the broad evidence rule combining the various definitions to reach the promised full indemnity. Since a first-party-property policy contains terms obligating the carrier to pay ACV first and then, after the property is replaced the difference between RCV and ACV, it is in the best financial interest of the insured to obtain the highest possible ACV, especially if the insured does not want to rebuild.

In *Sierra Pacific Power Co. v. Hartford Steam Boiler Inspection and Ins. Co.*, Slip Copy, 2014 WL 6883056 (D. Nev., 12/05/14) the United States District Court for the District of Nevada was called upon to resolve a dispute over the value of the Farad Dam on the Truckee River in California (the “Dam”) and the amount required to be paid to the owner of the Dam by its insurers after the Dam was destroyed by a flood. The owner claimed the ACV was RCV because the value of the Dam, when rebuilt, would be the same as it was before the loss. The insurers claimed ACV must be determined by RCV less physical depreciation. The case was tried, appealed to the 9th Circuit Court of Appeals, reversed, and retried.

**FACTUAL BACKGROUND**

Sierra Pacific operated power generation stations in Nevada and California. Defendants, Hartford Steam Boiler and Zurich insured Sierra Pacific’s facilities, including the Dam. After the Dam was completely destroyed by a flood in 1997, Sierra Pacific filed a claim for damages with Defendants.

Following a three-day bench trial the court awarded declaratory relief and entered judgment in favor of Sierra Pacific in accordance with the Court’s Findings of Fact and Conclusions of Law. The court determined that the ACV, with proper deduction for depreciation, of the Dam was $1,261,000. The court further determined that the replacement cost of the Dam totaled $19,800,000.

The parties appealed and the Ninth Circuit Court of Appeals issued a Memorandum vacating the Court’s finding that the ACV of the Dam was $1,261,200, and remanding for a determination of the ACV based on reducing the replacement cost of $19,800,000 by the “appropriate” depreciation, and to fashion an appropriate order tolling the three-year period for replacing the Dam until the conclusion of the litigation in the matter.

The Ninth Circuit rejected the proposed ACV of $1,261,200 because it was not related to the figure found as the replacement cost ($19,800,000).

On retrial, the trial court then held that based on the evidence presented, it was appropriate to apply a 50% rate of depreciation for the in-river Dam and a 5% rate of depreciation for the wing wall, and that subtracting this depreciation from the full replacement cost yielded an ACV of $12,216,600.

**DISCUSSION**

**Depreciation**

Sierra Pacific argued that the Court’s calculation of depreciation and ACV was incorrect.

Despite multiple opportunities—at trial and after the Ninth Circuit’s July 27, 2012 Memorandum—to present evidence regarding the proper depreciation rate to apply to the Dam, Sierra Pacific maintained that the Court should determine that the ACV was equivalent to replacement cost because the value of a newly constructed Dam would be equivalent to the destroyed Dam.

The Hartford and Zurich policies, however, each stated that valuation was “actual cash value (with proper deduction for depreciation) of the property destroyed.” The Ninth Circuit held that “[s]ince the Policy uses these precise words, the ACV should be determined as replacement cost less depreciation of the dam,” *Sierra Pac. Power Co. v. Hartford Steam Boiler Inspection & Ins. Co.*, 665 F.3d 1166, 1171 n. 2 (9th Cir.2012) because the term was clearly defined in the policy.

The Hartford and Zurich policies also included the standard California language on appraisal for disagreements that arise as to amount of loss. Notably, there was no evidence that Sierra Pacific ever demanded an appraisal to determine ACV of the Dam when it was destroyed. Additionally, although no document indicates that Sierra Pacific agreed to the 50% depreciation rate, Defendants testified at trial that Risley, a Sierra Pacific employee at the time, agreed to the 50% depreciation rate. Such an agreement would have voided Sierra Pacific’s argument that it was not bound by the 50% depreciation rate.
If Sierra Pacific decided to rebuild the Dam, it could recover prejudgment interest on the full replacement cost of $19,800,000, less the $1,600,000 deductible, and less Defendants’ $1,011,200 payment, beginning April 3, 2001. If, on the other hand, Sierra Pacific did not rebuild the Dam, it could recover prejudgment interest on the $12,216,600 ACV, less the $1,600,000 deductible, and less Defendants’ $1,011,200 payment, beginning April 3, 2001. Interest will accrue at ten percent per annum pursuant to California Civil Code § 3289(b).

The Court concluded that the ACV of the Dam was $12,216,600. If Sierra Pacific rebuilds the Dam, it shall be entitled to the full replacement cost of $19,800,000 less the deductible of $1,600,000 and less Defendants’ prior payment of $1,011,200, plus prejudgment interest on the replacement cost less the deductible of $1,600,000 and less Defendants’ prior payment of $1,011,200, effective respectively from the date of the loss and the date of the $1,011,200 payment.

The Court also reaffirmed its prior Order that the three-year period granted for rebuilding the Dam shall be tolled until the conclusion of the litigation. Due to the interest in maintaining reasonable prejudgment interest, Sierra Pacific could decide to rebuild the Dam or recover its ACV within ninety days of the conclusion of the litigation.

LESSON

The insurer could have saved the problem by not defining ACV or by defining it as fair market value, which is the California Supreme Court’s default definition if none other exists.

Because this case involves a great deal of money to replace the Dam, litigation ensued over the determination of ACV. Had the parties been interested in avoiding unnecessary litigation either the insurers or the insured could have demanded appraisal and allowed a panel of appraisers (arbitrators) to determine ACV and RCV. They chose to litigate, instead, and forced the court to determine the amount of loss. It did so, and now Sierra has three months to decide if it will rebuild the dam to recover the difference between the ACV and RCV. That they fought so hard to have ACV and RCV determined to be the same amount one could speculate that the plaintiff has no intent to rebuild.

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Cause of Loss.” Travelers denied coverage in part because Gregory Packaging did not suffer the “direct physical loss of or damage” to property required to trigger coverage.

Gregory Packaging, headquartered in New Jersey, filed a declaratory judgment action asking the district court to find coverage, and moved for partial summary judgment on the issue of whether the ammonia release constituted “direct physical loss of or damage”. In opposition, Travelers asserted that “physical loss of or damage” involves a “physical change or alteration to insured property requiring its repair or replacement,” and not the inability to use the manufacturing and packaging plant.

In granting partial summary judgment in Gregory Packaging’s favor and rejecting Travelers’ arguments, the district court found that under both New Jersey and Georgia law, substantial evidence had been presented showing that the ammonia discharge “rendered Gregory Packaging’s facility physically unfit for normal human occupancy and continued use until the ammonia was sufficiently dissipated.” The following facts were undisputed and critical to the holding: 1) Government authorities evacuated the area for a one mile radius after the incident; 2) The responding fire department would not allow anyone in the building on the date of the release and the following day; 3) The refrigeration contractor issued a work order summary the day after the incident that the ammonia level was too high for human occupancy; and 4) The remediation company washed down the plant with water and used fans to dissipate the ammonia levels as part of its clean-up efforts.

The district court relied on the finding in Wakefern Food Corp v. Liberty Mut. Fire Ins. Co., 968 A.2d 724, 727 (N.J. Super Ct. App. Div. 2009) that an electrical grid and its component parts were “physically damaged” when rendered physically incapable of performing its essential function of providing electricity. It should be noted that individual pieces of the grid experienced structural damage in Wakefern, but the Gregory Packaging, Inc. court found that the Wakefern decision rested on the “loss of function of the system as a whole.” The opinion also cited to dicta in the Third Circuit Court of Appeal’s decision in Port Authority of N.Y and N.J. v. Affiliated FM Ins. Co. that if the presence of large quantities of asbestos in the air of a building made it uninhabitable and unusable, there has been a distinct loss to the building owner that would constitute “physical loss.” 311 F.3d 226 (3d Cir. 2002). The district court found that the Wakefern and Port Authority decisions were rooted in the idea that property can be physically damaged, without undergoing structural alteration requiring repair or replacement, when it “loses its essential functionality.” The opinion also cited to cases in other jurisdictions that found buildings rendered uninhabitable by dangerous gases or by bacteria in the water supply experienced direct physical loss or damage.

The district court did not stop its analysis at stating that a building being rendered unsafe for occupancy constitutes direct physical loss or damage. The court also concluded that the ammonia release “physically transformed the air” within the plant so that it contained an unsafe amount of ammonia as an alternate ground for finding coverage to be triggered. The opinion did not elaborate further on whether a change in the content of the air constituted “direct physical loss of or damage to” property or whether air constituted property of the type insured by the insurance policy.

In granting partial summary judgment on the issue of “physical loss of or damage to” property, the opinion cautioned that the insured still had to prove that the damage was caused by or resulted from a “Covered Cause of Loss.” That question of whether the ammonia release qualifies as a covered cause of loss is currently under review by the district court after briefing by the parties.

The Gregory Packaging decision represents a continued evolution of courts finding that a property can experience physical loss where rendered unfit for habitation or occupancy without accompanying physical or structural alteration even where the incapacitation is temporary. There are numerous questions that remain from this decision. For example, what chemicals or substances...
would render a building unfit for occupancy? In *Universal Image Productions, LLC v. The Chubb Corp.*, by contrast, a federal district court in Michigan found that strong odors from water seepage and the presence of mold and/or bacteria in the air that caused the insured to abandon its production facility did not constitute “direct physical loss.” 703 F.Supp.2d 705, 709-10 (E.D. Mich. 2010). Also, what testing needs to be done for a court to determine whether the air has been transformed? The *Gregory Packaging, Inc.* court did not identify a minimal time period that the property under review needs to be rendered unfit for its intended use in order to trigger coverage. Is it one hour, one day, or more? Moreover, who makes the determination as to whether a building is rendered unfit? In *Gregory Packaging*, a fire department prohibited entry into the building on the day of the ammonia release and the following day. Would a court reach a different determination if a government authority had not prohibited entry? All these questions will continue to be pondered by courts as the scope of “direct physical loss of or damage to” property continues to be evaluated by courts in a wide variety of changing circumstances.

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**DOWNPOUR OR DOWNFALL:**

*Continued from page 6*

home or business that has been totaled due to a storm or hurricane, and the lawyers who represent them, there is nothing funny about these clauses. “The ACC clause can put the kibosh on your entire claim.” And for tens of thousands of Americans, it has.

Specifically, the ACC clause operates to exclude damage caused by an excluded event, such as flood, even if the flood was caused by wind or some other insured event. Untold numbers of people outside California have experienced financial devastation via this clause. United Policyholders’ staff and volunteers have battled it mightily in legislative, regulatory and court arenas with few successes. Our collective efforts are a work in progress.

Inside California, the ACC clause is inapplicable, due largely to California’s unique statutory provisions and the case law discussing efficient proximate cause. Fire following earthquake? Covered. No problem. A retaining wall that fails due to a combination of flooding and tree-fall? Covered. No problem. But a series of decisions in recent years and one pending in the Court of Appeal are creating confusion for practitioners on both sides of the issue.

**BACKGROUND**

The ACC clause emerged as a coverage killer after Hurricane Katrina. It had been showing up in homeowner policies since at least the 1980s, but it did not get much attention until 2005, when Hurricane Katrina wallop ed the Gulf Coast, costing insurers an estimated $38 billion in claims. Suddenly, the ACC became a devastating weapon for insurers to use to avoid paying claims.

Policyholder attorneys mounted numerous challenges with some success. But overall, insurers prevailed in getting most courts to uphold and enforce the clause. Their public relations message and rallying cry to courts and lawmakers: “If you rewrite our contracts after the fact and make us pay for claims we did not collect premiums for, we will go out of business.” The strategy worked - courts enforce these exclusions in most states.

In a recent decision, the New Jersey Appellate Division upheld an anti-concurrent/sequential causation clause that was used to preclude coverage for a Hurricane Irene loss in *Ashrit Realty, LLC v. Tower National Ins Co.* A covered peril (hidden decay in a pipe) led to an excluded peril (soil erosion due to inundation caused by pipe leaking storm water) which caused damage to the insured structure. The court found that the trial judge properly granted summary judgment because the policy excluded coverage for such a sequential loss and was designed to contract out of any obligation to pay for losses that might be covered in the causal chain by applying of the efficient proximate cause doctrine.

“Even if plaintiffs are correct in asserting that hidden decay was a cause of loss, plaintiffs do not dispute that water leaked from the collapsed culvert also causing soil erosion. Further, there is no dispute that soil erosion is excluded from coverage. Because these causes happened sequentially, the anti-sequential language in the policy excludes recovery.” [The trial judge properly granted summary judgment, finding that:] “The policy at issue that was drafted by the defendant was clearly drafted to eliminate the efficient proximate cause doctrine. Such an exclusion is not inconsistent...with public expectations, or commercially acceptable standards.”
So despite the fact that, “[w]hen disaster strikes it seems to happen all at once. Electric lines spark, windows shatter, roofs tear off, sump pumps stop and the lights go out. Homeowners see it this way. Insurance companies -- and often the courts -- see it differently,” ACC clauses continue to be upheld.

**JURISPRUDENCE**

Many standard form homeowners’ policies provide coverage for “all-perils not specifically excluded.” This means the policy pays for loss or damage resulting from any cause not specifically listed in the policy’s exclusion sections. Things get much more complicated when, in the case of a hurricane, multiple perils contribute to the same loss.

After the San Francisco Earthquake of 1906, considered by many to be a turning point in the law of causation, many homeowners were shocked to find that their standard fire insurance policy excluded both the earthquake damage and the ensuing fire. Litigation ensued. See, e.g., Pac. Heating & Ventilating Co. v. Williamsburgh City Fire Ins. Co. The California legislature responded by enacting a series of reforms regarding ensuing loss provisions and ACC clauses.

Now, a typical ensuing loss provision reads:

> In the event an excluded cause of loss… results in a covered cause of loss, the [insurance] company will be liable only for such resulting loss or damage.

By including the ensuing loss provisions, policies were reformed to provide coverage for fire following earthquake. See, e.g., Acme Galvanizing Co. v. Fireman’s Fund Ins. Co (“[c]overage where there is a ‘peril,’ i.e., a hazard or occurrence which causes a loss or injury, separate and independent but resulting from the original excluded peril, and this new peril is not an excluded one, from which loss ensues.”); but see Loughney v. Allstate Ins. Co. (“ensuing loss” provision is only applicable when an insured alleges damage resulting from a secondary peril which is covered).

The ensuing loss provision is the easy part. But an ACC clause can cause confusion when multiple perils contribute to the same loss and occur either simultaneously or in close proximity. For example, if both wind and flood damage property as a result of a storm, like in the Hurricane Sandy example discussed above, application of the ensuing loss provision in conjunction with an ACC clause causes confusion for both homeowners and reviewing courts.

At the time Hurricane Katrina hit the Gulf Coast, only 15 states enforced ACC clauses. That’s changing. Courts in Alabama, Alaska, Arizona, Colorado, Indiana, Louisiana, Massachusetts, Michigan, North Carolina, New Hampshire, Nevada, New Jersey, New York, Pennsylvania, South Carolina, South Dakota, Tennessee, and Texas have expressed their approval of the ACC. The ACC has only been formally rejected by courts in California, North Dakota, Washington, and West Virginia.

Some courts, such as in Mississippi, have enforced ACC clauses but have refused to extend them to loss or damage caused by a covered peril. See, e.g., Leonard v. Nationwide Mut. Ins. Co (“[i]f wind blows off the roof of the house, the loss of the roof is not excluded merely because a subsequent storm surge later completely destroys the entire remainder of the structure; such roof loss did occur in the absence of any listed excluded peril.”). California instead applied the “Efficient Proximate Cause” (“EPC”) doctrine for nearly half a century. See, e.g., Sabella v. Wisler. (“[a]n insurer is liable for a loss of which a peril insured against was the proximate cause, although a peril not contemplated by the contract may have been a remote cause of the loss; but is not liable for a loss of which the peril insured against was only a remote cause.”).

California’s application of the EPC is based on its statutory Insurance Code, which states, in relevant part: “[a]n insurer is liable for a loss of which a peril insured against was the proximate cause, although a peril not contemplated by the contract may have been a remote cause of the loss; but he is not liable for a loss of which the peril insured against was only a remote cause.”

In Garvey v. State Farm Fire Cas. Co., the California Supreme Court held:

> …whether a claim is covered or excluded under the terms of the policy turns not on whether the alleged cause
of the loss was a concurrent cause of
the damage, but whether it was the
‘efficient proximate cause’ of the loss.\textsuperscript{19}

Despite these directives, California courts continue to
confront the EPC/ACC issue with mixed results.\textsuperscript{20} Some
recent decisions suggest that the EPC doctrine is intact,
while others suggest that insurers are free to contract
around it, thus upholding a version of the ACC. \textit{See Julian v. Hartford Underwriters Ins. Co.} (“[a]n insurer is
liable for a loss of which a peril insured against was the
proximate cause, although a peril not contemplated by
the contract may have been a remote cause of the loss;
but he is not liable for a loss of which the peril insured
against was only a remote cause.”)\textsuperscript{21} \textit{But See De Bruyn
v. Sup. Ct.} ([EPC] does not preclude an insurer from
providing coverage for some, but not all, manifestations
of a peril, as long as the policy makes clear which perils
are and are not covered.)\textsuperscript{22}

\textbf{Vardanyan v. AMCO Ins. Co.,} a case with potentially
far-reaching impacts, is pending in a California Court
of Appeal.\textsuperscript{23} In the case, the trial judge refused the
plaintiff’s request for a jury instruction on predominant
cause (\textit{i.e.}, EPC):

You have heard evidence that the claimed
loss was caused by a combination
of covered and excluded risks under
the insurance policy. When a loss is
caused by a combination of covered and
excluded risks under the policy, the loss
is covered only if the most important or
predominant cause is a covered risk.

The judge instead relied upon a policy provision that
excludes coverage unless the covered peril was the \textit{sole}
cause of loss.\textsuperscript{24} In other words, the trial court held that
there was no coverage when any unnamed condition, no
matter how remote in time or effect, was in the causal
chain. An appeal is pending and insurance professionals
on all sides are awaiting the outcome.

\textbf{CORE PRINCIPLES}

In summary, the authors urge that the following
principles should always be part of a court’s analysis in
coverage and bad faith cases involving the ACC:

\begin{itemize}
  \item Insurance policies are contracts of adhesion;
        consumers have no power to alter their terms.\textsuperscript{25} \textit{See, e.g., D’Ambrosio v. Pa. Nat. Mut. Cas. Ins. Co.}\textsuperscript{26}
  \item “Courts carefully scrutinize adhesion contracts
        and sometimes void certain provisions because
of the possibility of unequal bargaining power,
unfairness, and unconscionability. Factoring into
such decisions include the nature of the assent,
the possibility of unfair surprise, lack of notice,
unequal bargaining power, and substantive
unfairness. Courts often use the “doctrine of
reasonable expectations” as a justification for
invalidating parts or all of an adhesion contract: the
weaker party will not be held to adhere to contract
terms that are beyond what the weaker party would
have reasonably expected from the contract,
even if what he or she reasonably expected was
outside the strict letter of agreement.” \textit{The Legal
Information Institute at Cornell Law School.}
  \item Many of the exclusions in property policies today
        were never analyzed or formally approved by a
        regulatory agency. Regulators do not have the
        resources or authority to scrutinize policy wording
        in every policy sold in their state. In many cases,
you will find that coverage is illusory through
cleverly worded clauses and exclusions.\textsuperscript{27}
  \item The business of insurance is different, not like
        a radio, television or car. It is affected with the
public interest and a quasi-utility.\textsuperscript{28} \textit{See, e.g., U.S.
v. South-Eastern Underwriters} (U.S. Supreme
Court).\textsuperscript{29}
  \item The purpose of an insurance contract is to effectuate
        indemnity in case of loss. “Delayed payment based
        on inadequate or tardy investigations, oppressive
conduct by claims adjusters seeking to reduce
the amounts legitimately payable, and numerous
other tactics may breach the implied covenant [of
good faith and fair dealing] because they frustrate
the insured’s right to receive the benefits of the
contract in “prompt compensation for losses.”
\textit{Waller v. Truck Ins. Exch., Inc.}\textsuperscript{30}
  \item The financial security that insurance policies
        provide is essential to economic health of
policyholders and the economy at large. When
insurers don’t pay, the results can be catastrophic.
Individuals fall down one or two rungs on the
economic latter. Businesses close. Bad news
all around. \textit{See, e.g., Amerigraphics v. Mercury
Casualty Co.}\textsuperscript{31}
  \item “The obligations of insurers go beyond meeting
reasonable expectations of coverage [and] ... encompass qualities of decency and humanity
inherent in the responsibilities of a fiduciary.”
\textit{Egan v. Mutual of Omaha.}\textsuperscript{32}
\end{itemize}
The duty of good faith extends to the drafting of the contract itself. If an exclusionary clause operates to defeat the reasonable expectations of indemnity, an insurer acts in bad faith by enforcing that clause.

As Professor Williston said:

The fundamental reason which explains [contra proferentem] and…judicial predisposition toward the insured is the deep-seated often unconscious but justified feeling or belief that the powerful underwriter, having drafted its several types of insurance contracts with the aid of skillful and highly paid legal talent, from which no deviation desired by an applicant will be permitted, is almost certain to overreach the other party to the contract. The established underwriter is magnificently qualified to understand and protect its own selfish interests. In contrast, the applicant is a horn lamb driven to accept whatever contract may be offered on a ‘take-it-or-leave-it’ basis if he or she wishes insurance protection…insurance policies, while contractual in nature, are certainly not ordinary contracts, and should not be interpreted or construed as individually bargained for, fully negotiated agreements, but should be treated as contracts of adhesion between unequal parties. This is because…insurance contracts are generally not the result of the typical bargaining and negotiating processes between roughly equal parties that is the hallmark of freedom of contract. 33

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3 Anthony Rifilato, Long Island Newsday, Sandy victims rally against NY Rising- Displaced homeowners express frustration 17 months after storm, April 1, 2014
8 Leefeldt, supra note 3.
11 Cal. Ins. Code §§ 2081, 1008, and 10088.5 forced insurers to include ensuing loss provisions in policies.
12 465 F. Supp. 2d 1039, 1042 (S.D. Cal. 2006)
15 399 F.3d 419, 431 (5th Cir. 2007).
16 10 Cal.3d 94 (1973)
17 29 Cal.2d 21 (1965).
20 For an extensive discussion of EPC and the ACC clause, see Jacqueline Young, Notes - Efficient Proximate Cause: Is California Headed for a Katrina-Scale Disaster in the Same Leaky Boat? 62 Hastings L.J. 757 (2011).
23 Case No. 11CECG02112, from a judgment by the Fresno Superior Court.
24 California Civil Jury Instruction (CACHI) 2306: Covered and Excluded Risks—Predominant Cause of Loss (2003).
27 Regulatory Brief: State Insurance Regulation: History Purpose and Structure, National Association of Insurance Commissioners (only half the states require insurers to submit property-casualty forms for prior approval).
28 "The insurers’ obligations are ... rooted in their status as purveyors of a vital service labeled quasi-public in nature. Suppliers of services affected with a public interest must take the public’s interest seriously, where necessary placing it before their interest in maximizing gains and limiting disbursements ... [A]s a supplier of a public service rather than a manufactured product, the obligations of insurers go beyond meeting reasonable expectations of coverage. The obligations of good faith and fair dealing encompass qualities of decency and humanity inherent in the responsibilities of a fiduciary. Insurers hold themselves out as fiduciaries, and with the public’s trust must go private responsibility consonant with that trust.” (Goodman & Seaton, Foreword: Ripe for Decision, Internal Workings and Current Concerns of the California Supreme Court (1974) 62 Cal.L.Rev. 309, 346-347.)
29 322 U.S. 533 (1944).
31 182 Cal.App.4th 1538 (2010) (when considering a punitive damages award, the court’s reprehensibility analysis focused on the fact that the insurer’s failure to pay caused the insured company to go out of business).
32 598 P. 2d 452, 24 Cal. 3d 809 (1979).
33 Williston on Contracts, 49:15.
## 2015 TIPS CALENDAR

### March 2015

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