ALM LAW JOURNAL NEWSLETTERS

The Insurance Coverage Law Bulletin®

Volume 5, Number 9 • October 2006

Conflict of Laws And Insurance Disputes

Choice of Law or Choice of Outcomes?

By Marc S. Mayerson

Most insurance policies are silent as to which state's substantive law governs their terms. As a result, insurance-coverage lawyers often find ourselves wading deep into the world of choice of law and conflict of laws. Conflicts issues are (largely) untethered from the merits of a case, yet can be outcome determinative; so it is crucial to understand and focus on choice-of-law principles in complex insurance disputes, as they can yield the application of different state laws within a single case to issues of contract formation, performance, and bad faith.

There are two paradigmatic approaches to choice of law, but nuances in every state affect the analysis. What one can call the First Restatement or *lex loci contractus* approach looks to some formal act involved in the making of a contract and holds that the location of that act tells one which state's law governs. Now more than 75 years old, several states still follow its teachings.

Then there is the Second Restatement approach, promulgated 30 years ago, which is plainly the dominant intellectual framework for choice of law in the United States. This looks to the state with the "most significant relationship" between the issue to be resolved and the states affected. *See*

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Is Defective Workmanship an 'Occurrence'?

The Jurisdictional Split Examined

Part One of a Two-Part Series

By Jay M. Levin

Under the terms of a standard Commercial General Liability ("CGL") policy, an insurance company must defend and indemnify its insured for claims of property damage (or bodily injury) resulting from an "occurrence" subject to certain enumerated policy exclusions. An "occurrence" is typically defined as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." CGL policies do not define the term "accident" and, consequently, the term has prompted substantial litigation. *See State Farm Fire & Cas. Co. v. CTC Dev. Corp.*, 720 So. 2d 1072, 1075 (Fla. 1998) (stating that "few insurance policy terms have provoked more controversy in litigation than the word 'accident'"). At the heart of the litigation is the parties' disagreement over what constitutes accidental damage.

Claims for property damage arising out of defective workmanship have provoked substantial litigation for decades and are increasing in a seemingly geometric progression. This has sparked a split in authority, with some courts holding that property damage resulting from defective workmanship is not an occurrence and others holding that it is. *See generally* William D. Lyman, Practising Law Institute, *Is Defective Construction Covered Under Contractors' and Subcontractors' Commercial General Liability Insurance Policies? Selected Issues*, 525 Real Estate Law and Practice Course Handbook Series 151 (Apr. 2006). Irrespective of the theory used, almost all courts ultimately find that a CGL policy provides coverage where the defective workmanship causes damage to third-party property. A CGL policy insures the risk that "the goods, products or work of the insured, once relinquished or completed will cause damage to property other than the product or completed work itself, and for which the insured may be found liable." Roger C. Henderson, *Insurance Protection for Products Liability and Completed Operations — What Every Lawyer Should Know*, 50 Neb. L. Rev. 415, 441 (1971). Construction defect coverage litigation focuses on

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Restatement 2d §§6, 188, 193. The Second Restatement analysis proceeds issue by issue, that is, one state's law can apply to one issue in a case and another state's law to a different one. (This is a principle called depeçage.)

In the absence of a contractual choice-of-law clause (which in any event is considered merely to be evidence of the proper choice of law and not determinative in and of itself), one can predict the governing substantive law only if one starts with a particular forum in mind. The choice of forum is not directly a selection of the forum's law; instead, it is a selection of the forum's rules for choice of law (there being no difference between suing in state or federal court on this issue, *Klaxon Co. v. Stentor Electric Mfg. Co.*, 313 US 487 (1941)).

The choice-of-law question is not what law governs this contract for all purposes, but rather what law should govern a particular issue for which there is a difference were one state's or another's law to apply. One law can govern a single contract issue or a discrete claims-handling issue, all depending on the interests of the state involved. Typically, the law of the forum applies unless and until a party demonstrates that another state's law should apply to a particular issue. *E.g., Trostel & Sons Co. v. Employers Ins. of Wausau*, 576 N.W.2d 88 (Wis. Ct. App. 1998). (Note also that some states have enacted choice-of-law statutes that will supersede the common-law choice-of-law analysis, so long as their application passes muster under constitutional principles. *See, generally, Sangamo Weston Inc. v. National Surety Corp.*, 414 S.E.2d 127 (S.C. 1992)).

The court's selection of a given state's law can change the result, which introduces great instability in the relationship between insureds and carriers given that a race to the courthouse may lead to one result (coverage) or the other (none). To be concrete, in one matter that I handled for the Michigan subsidiary of an Illinois corporate parent, we considered suing in South Carolina (where one of the carrier defendants was located), which would have resulted in the application of Georgia law (where the broker was located) and which we thought would be relatively favorable; instead, we sued in Illinois and argued successfully for the application of Illinois law to the contract (which we obviously perceived to be a bit more favorable than Georgia law). *See generally Babcock & Wilcox Co. v. Arkwright-Boston Manufacturing Mutual Ins. Co.*, 867 F. Supp. 573 (N.D. Ohio 1992); *Gabe's Construction Co. v. United Capitol Insurance Co.*, 539 N.W.2d 144 (Iowa 1995) (additional-insured issues); *Auto Europe, LLC v. Connecticut Indemnity Co.*, 321 F.3d 60 (1st Cir. 2003) (location of subsidiary in forum an important contact even where parent negotiated policy). In that case, we were seeking insurance recovery for a nationwide product-liability problem, involving possible death cases and a nationwide, multi-industry product recall and replacement program involving the Consumer Products Safety Commission ("CPSC"). That, on the same facts, it was possible for Georgia's, Illinois', or even Michigan's laws to apply should underscore the malleability of the issue as well as the importance of considering choice-of-law carefully in deciding how to manage insurance recovery. *See Piper Aircraft Co. v. Reyno*, 454 U.S. 235, 250 (1981) ("Ordinarily, these plaintiffs will select that forum whose choice-of-law rules are most advantageous.").

Additional complexity is introduced when one considers insurance bad-faith issues or similar remedial measures that may exist both at common law and as a matter of statute in individual states. The question in part concerns due process: Does the state legislature have the power to regulate the conduct at issue? The question may also involve choice of law: Does the state's law apply to the transaction at issue? Ever since the U.S. Supreme Court decision of *Allstate Ins. Co. v. Hague*, 4498 U.S. 302 (1981), which was a 4-1-3 decision (with one recusal), the analysis has been

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The Insurance Coverage Law Bulletin® (ISSN 1541-0773) is published by Law Journal Newsletters, a division of ALM.

Telephone: (800) 999-1916
Editorial e-mail: jgromer@alm.com
Circulation e-mail: subspa@alm.com
The Insurance Coverage Law Bulletin 023148
Periodicals Postage Paid at Philadelphia, PA
POSTMASTER: Send address changes to:
ALM
1617 JFK Blvd., Suite 1750, Philadelphia, PA 19103
Annual Subscription: $349

Published Monthly by:
Law Journal Newsletters
1617 JFK Boulevard, Suite 1750, Philadelphia, PA 19103
www.ljnonline.com

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collapsed into the choice-of-law inquiry alone, eschewing examining the power of a state to regulate conduct. As the Third Circuit has explained:

> [T]he relevant issue is the constitutionality of a choice of substantive law (not constitutional limitations on the permissible scope of a state's substantive law). In our case we must ask whether New York's substantive law would constitutionally apply to the facts we review, not whether New York could permissibly choose to apply its law (the choice of which substantive law to apply being an issue reserved to Pennsylvania law). *Budget Rent-a-Car System, Inc. v. Chappell,* 407 F.3d 166, 176 (3d Cir. 2005).

Through the 1940s and 1950s, there were a series of U.S. Supreme Court cases that approached these types of questions by looking at Due Process, Equal Protection, and Full Faith and Credit. Some of these cases have fallen into disfavor under *Hague,* but others were cited in *Hague* and thus have continued vitality. *E.g., Watson v. Employers Liability Corp.,* 348 U.S. 66 (1954). I have argued in a case that *Watson* dictates that the forum (Virginia) state's statute on bad faith applies to benefit the (former) Virginia subsidiary of a Washington, DC, company that purchased insurance from a New York company and that suffered a fidelity loss through the operation of a (sub)subsidiary in New Hampshire. On its face, the statute applied to admitted insurers doing business in the state (as was true in my case), and we posited that the legislature meant to protect Virginia citizens from the misdeeds of foreign, but admitted, insurers. While we could run that argument under choice-of-law principles, *e.g., Babcock & Wilcox,* 867 F. Supp. 573, to me it makes more sense to approach the matter as one of the scope of legislative authority, which is what *Watson* speaks to.

The Supreme Court's decision in *Watson* is not a choice-of-law case, but rather concerns the constitutionality of applying a state insurance statute. *Watson* involved Louisiana's direct-action statute, which conflicted with a provision in the insurance policy that

As* Watson *anticipates, coverage disputes can involve the application or potential application of the law of more than one state within a given case.

provided that no action could proceed against the insurer until the underlying tort claim was resolved. Given that the dominant approach to selecting which law to apply involves consideration of which state "would have the strongest interest in seeing its laws applied to the particular case," *United Western Grocers, Inc. v. Twin City Fire Ins. Co.,* slip op. at 9550 (9th Cir. Aug. 14, 2006) (citation omitted). *Watson* remains relevant in assessing state interest.

At issue there was a bodily injury claim stemming from the use in Louisiana of a home hair-care product manufactured by an Illinois subsidiary of a Massachusetts company where the insurance policy was negotiated and issued in Massachusetts and delivered in Massachusetts and Illinois. "The basic issue raised ... is whether the Federal Constitution forbids Louisiana to apply its own law and compels it to apply the law of Massachusetts or Illinois." 348 U.S. at 69. The plaintiff was a tort victim with no privity of contract seeking to force the insurer to provide coverage to the defendant-tortfeasor, the Illinois company.

The Supreme Court ruled that Louisiana had an interest in applying its law because the tort victims, while strangers to the contract, were Louisiana residents who obtained medical care in Louisiana and drew upon other Louisiana private and public services in connection with their injuries. "Where, as here, a contract affects the people of several states, each may have interests that leave it free to enforce its own contract policies" 348 U.S. at 73. "[M]ore states than one may seize hold of local activities which are part of multistate transactions and may regulate to protect interests of its own people, even though other phases of the same transactions might justify regulatory legislation in other states." 348 U.S. at 72.

As *Watson* anticipates, coverage disputes can involve the application or potential application of the law of more than one state within a given case. Two recent federal district court decisions addressed choice of law in the context of both coverage questions and alleged bad-faith conduct. A comparison between them highlights the vagaries of judicial outcomes in this area. (Choice-of-law decisions are invariably fact bound, so it is always difficult to conclude that rulings are inconsistent.) In one case, an out-of-state statute was held not to be available for bad-faith conduct by claims handlers occurring in that jurisdiction; in the other, while the bad-faith acts took place in a different state — the jurisdiction whose law plainly governed the coverage questions — the court nonetheless applied the law of bad faith where the effects of that conduct were felt and thus afforded a more vigorous remedy to the policyholder who had moved to a different jurisdiction after the policy period.

In *Cecilia Schwaber Trust Two v. Hartford Accident & Indem. Co.,* 2006 WL 1888691 (D. Md. June 26, 2006), the policyholder sought coverage as construed under Maryland law with regard to a property located in Baltimore but sought to impose bad-faith liability on the insurer based on the location of the insurer's claims handlers (Pennsylvania). The federal district court held that Maryland had an affirmative policy against allowing first-party bad faith claims (that is, claims for unreasonable denials of

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coverage), which the policyholder sought to sidestep by arguing that the location of the wrong at issue — bad-faith claim denial — occurred in Pennsylvania, whose law should apply under principles of *lex loci delicti*. The court ruled, however, that although Pennsylvania's bad-faith scheme is implemented pursuant to a statute, the question was controlled by what law properly governed the contract/coverage claim. *Id.* at *3.

> Moreover, the court observed:
>
> Plaintiffs are Maryland residents pursuing a claim for damage to a Maryland property under an insurance contract they admit is governed by Maryland law. Maryland has consistently refused to permit tort claims based on bad faith conduct by insurers ... I am confident that Maryland would not choose to import tort claims from other states in a case such as this, particularly when those tort claims are not intended to protect Maryland residents. *Id.*

The court sought to buttress its conclusion by arguing that the mirror-image result would likewise be absurd: That is, if a Pennsylvania policyholder with Pennsylvania property suffered bad faith at the hands of a Maryland-based claims handler, then the Pennsylvania citizen would have no bad-faith remedy. *Id.* at n.3.

But the problem of analytical symmetry posited by the *Schwaber* court does not exist: There is nothing inconsistent for choice-of-law purposes in applying Pennsylvania law on claims-handling conduct to claims handlers dealing with Marylanders and applying Pennsylvania law *also* to claims handlers dealing with Pennsylvanians, so long as the claims handlers in each instance are located and licensed in Pennsylvania. Pennsylvania can well have an interest in ensuring that all insurance operations conducted in its state conform to its standards. (New York for example has always sought to require licensed insurers to conform to the standards of New York wherever they may operate.)

A useful contrast to the Maryland case is another federal court decision decided 1 week before, *Love v. Blue Cross and Blue Shield of Georgia, Inc.*,

That an insurance contract was issued and delivered in Massachusetts did not preclude the application of Louisiana law in* Watson, *where Louisiana had a more direct and concrete interest in the particular dispute before the court.

2006 U.S. Dist. LEXIS 42275 (D. Wis. June 20, 2006). In *Love*, the insured purchased a health-insurance policy in Georgia and was a permanent resident there. Later, the insured moved to Wisconsin, and the dispute concerned the handling of certain bills submitted for treatments received in Wisconsin.

The question presented was whether a Georgia statute, which limited bad-faith remedies, applied or whether Wisconsin common law did. The insured applied for coverage in Georgia, lived in Georgia, and Georgia law applied to construe the policy. The court stated that applying the law of wherever the insured roamed to would lead to "confusion, not predictability, in the law." *Id.* at *7. Consequently, the court concluded that "predictability of results is fostered when a state's substantive law applies to a policy issued in that state by a state corporation to a resident of that state, especially when, as here, the policy in question explicitly states that Georgia law should apply." *Id.*

Nevertheless, the court concluded that Wisconsin had a strong interest in protecting Wisconsin residents regarding services provided in Wisconsin, even from an out-of-state insurer that issued a policy under out-of-state law to someone who then lived outside the state. *Id.* at *11-12. This was true even though "a policy issued in Georgia to Georgia residents might well cost less because of the damage caps the [Georgia] state legislature has put in place" and "the processing of the claims occurred in Georgia." *Id.* at *9, *12. As the court concluded, "Wisconsin has indicated its belief that bad faith is a tort for which a wide array of damages [should be] available, and it has a strong interest in ensuring that its residents receive full compensation for such torts." *Id.* at *19.

That an insurance contract was issued and delivered in Massachusetts did not preclude the application of Louisiana law in *Watson*, where Louisiana had a more direct and concrete interest in the particular dispute before the court. A Maryland policyholder suffering bad faith at the hands of Pennsylvania claims handlers perhaps should have the same remedies that a resident of Pennsylvania would have in the same circumstances, *Schwaber* notwithstanding. The former Georgia policyholder in *Love* was found to have the same remedies available as Wisconsin residents because the impact of the insurer's alleged post-policy bad-faith conduct occurred there, even though performance otherwise would be gauged under Georgia law.

Conclusion

The choice-of-law issue, albeit seemingly divorced from the merits, can determine who wins or loses a coverage case. *See Fluke Corp. v. Hartford Acc. & Indem. Co.*, 7 P.3d 825 (Wash. App. 2000), *aff'd*, 34 P.3d 809 (Wash. 2001) (finding insurance coverage for punitive damages following choice-of-law analysis). Given the current regime of state-by-state regulation of the insurance industry and the absence of choice-of-law provisions in policies, fighting over which law to apply (and to which issues) is one more crucial battle in complex insurance disputes.

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