

A Quarterly Newsletter from the Law Firm of Mound Cotton Wollan & Greengrass LLP

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## Introduction

Attorneys at Mound Cotton Wollan & Greengrass LLP are prolific authors. We keep abreast of the legal issues that affect our clients and industries in which they operate. We regularly publish and are often called upon to write for a number of industry-related publications worldwide.

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## Sorry For The Delay

By: Hilary M. Henkind, CPCU

*If you could count on anything, it would be that our partner, Dan Markewich, would spend at least a few minutes at each partner meeting talking about the Mound Cotton Newsletter. The Newsletter was something he took pride in, often reminding the partners that it had won a Burton Award for Newsletter excellence! Every month, after listening to Dan speak about the Newsletter, I would contemplate submitting an article. Somehow, I never found the time. After our January 2017 meeting, however, I vowed that this would be the month that I would finally write that article. I could not wait to tell Dan. Sadly, on February 2, 2017, Dan passed away. Dan, wherever you are, here at last is my article. Sorry for the delay and please excuse any grammatical errors!*


Many commercial property policies, including builders risk policies, contain an exclusion for “delay, loss of market, or loss of use.” Oftentimes, a property damage loss leads to some sort of delay, whether it be a delay in production, in completion of a project, or in opening an insured facility. Read literally, the delay exclusion would preclude coverage for any sort of loss of revenue, even if the delay or loss of use were the direct result of a covered cause of loss to covered property. Such an interpretation, however, seems to conflict with the inclusion of coverage for loss of business income. In this regard, a policy containing business income coverage obviously contemplates recovery for loss of revenue during the time following covered physical loss or damage when the insured is unable to operate, produce goods, or complete a project. These types of economic, post-loss delay claims generally seem to be covered in situations where an insured purchases business interruption coverage. Thus, it is necessary to reconcile the delay exclusion with the business income or extra expense coverage grant.

In *Archer-Daniels-Midland Co. v. Phoenix Assur. Co. of New York*, 975 F. Supp. 1137 (S.D. Ill. 1997), the U.S. Coast Guard halted barge traffic on the Mississippi River because of flooding. As a result, many of the insured’s

barges were delayed and the grain on the barge deteriorated. The insured, ADM, sought coverage under its Marine Policy for damage to the grain. The insurer argued that ADM’s losses were excluded by the policy’s “Delay Clause,” which excluded “loss of market or for loss, damage or deterioration arising from delay whether caused by a peril insured against or otherwise.” ADM argued that the Delay Clause was inapplicable because the proximate cause of its loss was flood, not delay.

Citing to *Brandyce v. U.S. Lloyds*, 207 A.D. 665, 203 N.Y.S. 10, aff’d, 239 573 (1924), ADM contended that “mere delay” is different from a “delay caused by an insured peril.” In *Brandyce*, the insured had a Marine Policy that covered a cargo of potatoes in shipment from New York to Cuba. While at sea, the ship collided and had to be put into Charleston, South Carolina for repairs. While the ship was being repaired, the potatoes began to rot and had to be sold at a discount. The court held: “If the ship had not been damaged by reason of sea perils, the potatoes would have arrived sound. The proximate cause of the loss, therefore, was the sea peril, because it was the efficient dominant cause which, although incidentally involving delay, placed the cargo in such a condition that, because of inevitable deterioration or decay, it could not be reshipped and carried to its destination.” The court in *ADM*, though, distinguished *Brandyce*, observing that the delay clause in the policy issued to ADM specifically stated that the delay exclusion applied “whether caused by a peril insured against or otherwise.” It was noted in *ADM* that, “[p]rior to the addition of [the phrase ‘whether caused by a peril insured against or otherwise,’], cases such as *Brandyce* . . . suggested that losses caused by delay are covered if the delay was caused by an insured peril. With the addition of this language . . . it is irrelevant whether the delay was caused by an insured peril.” *ADM*, 975 F. Supp. at 1147.

Accordingly, in situations where the delay exclusion contains the language “whether caused by a peril insured against or otherwise,” the exclusion likely

would operate to preclude coverage for all monetary damages arising out of a delay, even in situations where the delay was the direct result of a covered peril. The delay exclusions in most commercial property policies, however, do not include the phrase “whether caused by a peril insured against or otherwise.” Case law suggests that, in the absence of this phrase, a court would likely conclude that the monetary costs associated with a delay arising out of a covered peril would be covered, assuming, of course, that the insured has purchased business interruption insurance. By contrast, a delay exclusion would apply in situations where, unrelated to any covered cause of loss, a project is running behind schedule and the insured incurs delay penalties.

For instance, in *Channel Fabrics, Inc. v. Hartford Fire Ins. Co.*, 2012 WL 3283484 (S.D.N.Y.), the insured shipped a number of bales of woven fabric from Shanghai, China to a buyer in Guatemala. The insured’s shipment of fabric arrived a month late, causing the insured to have to sell the fabric at a discounted price. In addition, the insured contended that a portion of the fabric arrived in a damaged state. Citing to the policy’s exclusions for consequential loss and delay, the insurer took the position that the insured’s claim for the \$156,827 discount offered to the customer was excluded. The court held that, to the extent the price discount was applied to undamaged bales of fabric, the losses attributable to this delay would be excluded. On the other hand, the court noted, to the extent the insured could demonstrate that any portion of the discounted price related to the sale of the damaged goods, that portion of the loss could be recoverable. *Id.* at \*10.

Similarly, in *Diamond Beach, V.P., L.P. v. Lexington Ins. Co.*, 748 F. Supp. 2d 648 (S.D. Tx. 2010), Lexington issued a builder’s risk policy for the construction of a building in Texas. The building was under construction when Hurricane Ike made landfall in September 2008, causing physical damage to the building. As a result of the building damage, the scheduled date of completion was extended by an additional fifty-one days. After application of a thirty-day deductible, Lexington paid the twenty-one-day delay claim. Separate and apart

from this initial delay claim, the insured submitted a supplemental delay claim relating to the delay in the start of roofing work because of manpower constraints following Hurricane Ike and the delay in completing the drywall because the Building Department was overwhelmed with inspections of various buildings damaged during Hurricane Ike.

The policy excluded “consequential loss, damage or expense of any kind or description including but not limited to loss of market or delay, liquidated damages, performance penalties, penalties for non-completion, delay in completion, or non-compliance with contract conditions, however the foregoing shall not exclude Delay in Completion Coverage when it is endorsed to this Policy.” The policy contained a Delay in Completion endorsement, but that section contained an exclusion for any “change order or other cause which results in deviation from the original progress schedule, or revisions thereto, and which is independent of insured loss or damage which gives rise to a delay, whether occurring prior to or after an insured delay.” The court noted that some damage was, indeed, a result of Hurricane Ike, but that there was no hurricane damage associated with the roof or drywall. The court concluded that the only covered delay costs would be those associated with the physical damage to the building and that delays associated with the roof installation and wallboard inspection, which were not directly the result of physical damage to the insured building, would be excluded under the delay exclusion.

In *Oregon Shakespeare Festival Ass’n v. Great Am. Ins. Co.*, 2016 WL 3267247 (D. Or.), the court also recognized the distinction between delay caused by a covered cause of loss and delay from an external event. In that case, the insured operated an open-air theater. During the summer of 2013, smoke from several wildfires was present in the area, resulting in soot and ash accumulation on the seats of the theater as well as poor air quality. For a period of time while the smoke was present, the insured canceled various performances because of its concern for the health effects on its patrons and the actors. The insured submitted an insurance claim for loss of income associated with the cancellation of various shows.

Great American contended that there was no covered physical loss or damage and that, in any event, the delay exclusion applied to preclude coverage.

The court concluded that the accumulation of smoke and ash in the area of the theater constituted direct physical loss or damage. With respect to the delay exclusion, the court noted that the delay and loss of use of the theater was caused by smoke — a covered cause of loss. The court went on to state that the delay exclusion “only makes sense in the context of the policy when a delay external to the damage causes a loss of use. For instance, in this case if the actors and production staff of [the insured] were not ready to perform at the scheduled time, causing a delay or cancellation of a show, such loss of business income would not covered by the policy. There is no contention of an external delay here.” *Id.* at \*6. See also *Blaine Richards & Co., Inc. v. Marine Indem. Co. of America*, 635 F.2d 1051 (2d Cir. 1980) (where the FDA detained a shipment of beans after noticing an empty can of pesticides on the ship, the court held that, absent a showing that the beans were physically damaged by pesticides, the rejection of beans by purchasers would be excluded under the delay clause inasmuch as the loss would be attributable solely to delay caused by detention of the ship).

Despite the various cases holding that the delay exclusion applies only to delays unrelated to a covered loss, there are several cases interpreting builders’ risk policies in which the courts held that an exclusion for “delay, loss of use or loss of market” applies even if the delay in completion of the construction project resulted directly from covered damage under the policy. In *One Place Condominium, LLC v. Travelers Prop. Cas. Co. of America*, 2015 WL 2226202 (N.D. Ill.), the insured was in the process of constructing a ten-story building with a one-story basement. Not long into the construction project, the builders experienced problems with the foundation that resulted in damages and the need for

repairs. A stop work order was issued and then lifted approximately five weeks later. The policy contained an exclusion stating that the insurer “will not pay for ‘loss’ caused by or resulting from . . . Delay, loss of use or loss of market.” The insured argued that the general delay exclusion was only for loss caused by delay, not for costs caused by delay. The court found this argument illogical because “the only way to pay for a loss is to pay the costs associated with that loss.” The court noted that the insurer was agreeing that there was covered damage, but was denying coverage for the type of costs, i.e. delay costs, sought by the insured. Thus, the court upheld the insurer’s denial of the delay claim.

Notably, the court upheld the delay exclusion, despite the fact that the delay arose directly from the covered loss and the delay exclusion did not contain language (as discussed above in *ADM*) stating “whether caused by a peril insured against or otherwise.” Significant to the court’s decision was the fact that the insured had purchased soft cost coverage allowing the recovery of four types of soft costs (interest on money borrowed to finance construction, advertising expenses, realty taxes, and costs resulting from renegotiation of leases or construction loans) resulting from delay in completing the insured project because of damage to the covered property.

In sum, it appears that courts generally will allow recovery for delay costs associated with covered damage; however, if a policy provides coverage for specific delay costs, a court may be more inclined to exclude other delay costs not specifically enumerated. As always, it is important to read the policy without delay (pun intended!) in the event of a loss.

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# Starting Over: A Look at Policy Rescission in New York and the U.K.

By: Jeffrey S. Weinstein and Kelly A. Cheverko

It is an unfortunate fact of life for insurers and insurance coverage defense attorneys that courts often lean the insured's way in matters of policy interpretation. This axiom also carries through in many jurisdictions when insurers accuse the insured of concealing or misrepresenting information during the underwriting process. It is therefore extremely important that insurers know all the important information about an insured when choosing whether—and on what terms—to underwrite a policy. One way for insurers to ensure that they are not left holding the bag if an insured misrepresents information on its insurance application is to rescind the policy, which voids the contract *ab initio*. But, what are the circumstances under which an insurer can take such measures?

This important topic has recently been addressed under the laws of New York and the U.K. Interestingly, both jurisdictions tend to favor the insurer but take different approaches to policy rescission. While an insurer subject to New York law may rescind a policy for material misrepresentation regardless of whether the insured's misrepresentation was intentional, U.K. law now provides different remedies based on the insured's conduct and the actions the insurer would have taken had it properly been informed of all of the circumstances surrounding the misrepresentation.

## I. New York

New York Insurance Code § 3105 provides that “[n]o misrepresentation shall void any contract of insurance or defeat recovery thereunder unless such misrepresentation was material. No misrepresentation shall be deemed material unless knowledge by the insurer of the facts misrepresented would have led to a refusal by the insurer to make such a contract.”

In *H.J. Heinz Co. v. Starr Surplus Lines Insurance Co.*, 15cv0631, 2016 WL 374307 (W.D. Pa. Feb. 1, 2016), the United States District Court for the Western District of Pennsylvania, applying New York

law, set forth the proper standard for rescission of an insurance contract where material facts were omitted from the insured's application. This case recently was affirmed by the Third Circuit Court of Appeals.

*Heinz* sued Starr for \$25 million for breach of contract, declaratory judgment, and bad faith based on Starr's denial of Heinz's claim under its product contamination policy. Starr counterclaimed, seeking, among other things, rescission of the policy. The basis of the counterclaim was that Heinz knowingly and in bad faith omitted from its insurance application material information regarding its loss history. Namely, Heinz stated that it had not been the subject of any regulatory complaints within the prior twelve months and had not had any fines assessed by a regulatory body in the prior three years. It also failed to inform Starr of a 2014 Chinese recall involving its baby cereal products, a 2013 recall involving baby food contaminated with mercury, and other smaller losses. Heinz argued that the alleged misrepresentations were not material and that Starr had “actual notice” of the allegedly falsely represented or withheld information.

After a trial in December 2015, the jury found that there was a material misrepresentation of facts in the insurance application, but that Starr did not prove by clear and convincing evidence that Heinz deliberately omitted material information during the application process. The jury also found that Starr had waived its right to assert a rescission claim by agreeing to sell the policy despite having sufficient knowledge of the misrepresentation.

After the jury reached its conclusions, the district court ruled that the “extraordinary equitable remedy” of rescission was appropriate. It stated that “New York case law instructs that both intentional and unintentional misrepresentations will void a contract of insurance if the misrepresentation is material.” The court agreed with the jury that Heinz made material



representations of fact, and upheld the jury's conclusion that Heinz did not *deliberately* omit or remain silent with respect to the information.

The court found, however, that Starr had not waived its right to assert a rescission claim. According to the court, “[w]hile Starr was not ‘perfect’ in its assessment and underwriting practices, perfection is not the standard,” and “Starr acted more than reasonably under the circumstances.” The amount of material in the underwriting file that referred to the relevant information “without more, would not trigger a reasonably prudent insurer to follow-up further.”


Other New York courts have made clear that a “misrepresentation is material, and could warrant rescission by an insurer if, ‘had [the fact] been revealed, the insurer or reinsurer would either not have issued the policy or would have only at a higher premium.’” *U.S. Underwriters Ins. Co. v. Novel Home Health Care Servs. of N.Y., Corp.*, No. 14CV3715ARRCLP, 2016 WL 5339358, at \*4 (E.D.N.Y. Jan. 14, 2016) (citations omitted); *see also*, Andrew Amer & Linda H. Martin, *The Standard of Materiality for Misrepresentations Under New York Insurance Law - A State of Unwarranted Confusion*, 17 Conn. Ins. L.J. 415 (2011) (A misrepresentation “is material where it appears that a reasonable insurer would be induced by the misrepresentation to take action which he might not have taken if the truth had been disclosed”) (citation omitted). In other words, “the insurer does not have to prove that it would not have issued *any* policy to the insured, but rather that it would not have issued the specific policy in question. *Novel*, 2016 WL 5339358, at \*4.

## II. United Kingdom

The law of rescission in the U.K. is now governed by The Insurance Act 2015 (“the Act”), which received Royal Assent on February 12, 2015 and applies to all U.K. insurance policies entered into on or after August 12, 2016, including renewals. Unlike the rule at issue in Heinz, the Act provides different remedies depending on the insured's conduct and what the insurer would likely have done had it known the full facts.

Under the Duty of Fair Presentation portion of the Act<sup>1</sup>, which applies only to non-consumer insurance contracts, “the insured must make to the insurer a fair presentation of the risk.” A fair presentation of the risk is one that: 1) discloses “every material circumstance which the insured knows or ought to know” or, “failing that, gives the insurer sufficient information to put a prudent insurer on notice that it needs to make further enquiries for the purpose of revealing those material circumstances”; 2) makes the disclosure “in a manner which would be reasonably clear and accessible to a prudent insurer”; and 3) ensures that all material representations with respect to facts are “substantially correct” and all material representations “as to a matter of expectation or belief [are] made in good faith.” If the insurer does not inquire, the insured need not disclose circumstances that diminish the risk that the insurer knows, ought to know, or is presumed to know, or circumstances as to which the insurer “waives information.”

The Act defines material circumstances as ones that “would influence the



judgment of a prudent insurer in determining whether to take the risk and, if so, on what terms.” The Act provides examples of material circumstances, including “special or unusual facts relating to the risk,” “any particular concerns which led the insured to seek insurance cover for the risk,” or “anything which those concerned with the class of insurance and field of activity in question would generally understand as being something that should be dealt with in a fair presentation of risks of the type in question.”

The Act provides remedies for “qualifying breaches” where the insurer can show that, if not for the breach, the insurer either would not have entered into the contract at all or would have entered into it under different terms. A qualifying breach is 1) either deliberate or reckless (i.e., the insured knew that it was in breach of the duty of fair presentation or did not care whether it was in breach or 2) neither deliberate nor reckless.

Schedule 1 of the Act provides the insurers’ remedies for qualifying breaches. Where the qualifying breach was deliberate or reckless, the insurer may avoid the contract and refuse all claims, and is not required to return any of the premium paid.

The Act then considers several circumstances concerning qualifying breaches that were neither deliberate nor reckless. If the insurer would not have entered into the contract at all if it were aware of the true facts, it may avoid the contract but must return all premium. If the insurer would have entered into the insurance contract on different terms—other than terms relating to the premium—the contract is to be treated as though it had been entered into on those different terms, if the insurer so requires. If the insurer would have entered into the contract but charged a higher premium, the insurer is permitted to reduce proportionately the amount to be paid on a claim using the formula provided by the Act.

### III. Which Approach is More Favorable, and to Whom?

The New York approach is simpler in application because only two requirements need be met: first, the misrepresentations must be material, and second,

knowledge of the misrepresented facts would have led to the insurer’s refusal to enter into the contract. Once those requirements are established, the court need not undertake an analysis of whether the misrepresentations were intentional. Additionally, the *Heinz* decision makes clear that, even where an insurer is imperfect in its underwriting of the policy, as long as it acts reasonably with respect to ascertaining all of the available facts, it will not be deemed to have waived its right to rescind.

On the other hand, policy rescission under U.K. law now requires an analysis of whether the insured’s misrepresentations were intentional and what actions the insurer would have taken had it been aware of all the material facts. The various remedies available under the Act require courts to undertake a detailed analysis of the intentions of the parties and then a calculation of the proper claim payment.

In both jurisdictions, the burden is on the insured to convey information accurately. For the insurer, however, it appears that New York law is a bit more favorable overall. This is because the insurer need not show whether the breach was intentional. Moreover, under New York law a policy can be rescinded if the insurer can establish that it would not have entered into the contract as written if it were aware of all the material facts. On the other hand, the new U.K. law provides different remedies based on the insurer’s reaction to the misrepresentation, i.e.: 1) the insurer would not have entered into the contract at all; 2) the insurer would have entered into a contract but on different terms; or 3) the insurer would have entered into the contract but charged a higher premium.

The one circumstance in which U.K. law may be more favorable than New York law is the scenario where an insured *intentionally* misrepresents the facts and the insurer would not have entered into the insurance contract at all had the full facts been known. Under both New York and U.K. law, the policy would be void *ab initio*; under New York law, however, the insurer would have to return the premium to the insured while under the new U.K. law the insurer would not have to return the premium. If it is determined that an insured



*unintentionally* misrepresented the facts and the insurer would not have entered into the insurance contract had the full facts been known, under both New York and U.K. law the policy would be void *ab initio* and the insurer must return the premium.

The more favorable attributes of New York law are illustrated in circumstances in which the insurer would still have entered into the contract had it known the correct facts, but would have charged a lower premium or would have changed the terms. In such instances, different remedies are available under U.K. law, whereas in New York the insurer would be entitled to rescission.

The bottom line for insurers is to pay close attention to the application

process and to be prepared to articulate the effect and ramifications of a material misrepresentation by an insured. And while both New York courts and U.K. courts can be favorable to an insurer in these situations, there are still issues of proof that an insurer must be prepared to discuss in order to seek rescission of a policy.

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1. Insurance Act 2015, Part 2, The Duty of Fair Presentation, *available* at <http://www.legislation.gov.uk/ukpga/2015/4/part/2/enacted>.

## Social Media and The Rules of Professional Conduct: Is LinkedIn Attorney Advertising?

By: Barry R. Temkin

Lawyers who maintain active social media presences should be aware of two recent opinions by ethics committees in New York discussing the extent to which lawyers' postings on the social media page LinkedIn constitute attorney advertising in New York. These committees addressed the extent to which lawyers' social media postings subject them to regulation for attorney advertising within the meaning of the New York Rules of Professional Conduct. See, NYC Bar Association Formal Opinion 2015-7, Application of Attorney Advertising Rules to

LinkedIn, NYC Bar Association; NYCLA Professional Ethics Committee, Formal Opinion 748<sup>†</sup>. For example, is the mere listing of biographical information on LinkedIn sufficient to constitute attorney advertising, so that the copy must be preserved for a period of one year and designated as such? Or, as the City Bar posits, is it more appropriate to look to the primary purpose of the posting to determine whether the lawyer's subjective intent was to garner the retention of the lawyer or law firm? This article attempts to reconcile the views and perspectives of these committees to



provide guidance to practicing lawyers in New York.

Regulation of attorney advertising in New York begins with the New York Rules of Professional Conduct, in particular RPC 7.1, which, in subdivision (a), generally proscribes advertising that is false, deceptive or misleading. While permitting certain advertising, including basic biographical information, bank references, legal fees charged and, with written consent, the names of clients regularly represented, RPC 7.1 generally forbids other types of advertisements, including, among other things, paid endorsements or testimonials without disclosing that the portrayal is by a paid actor, or the use of a fictitious law firm. See, RPC 7.1(c). Whether an internet posting constitutes attorney advertising is important, as the rules require advertising copy to be labeled “Attorney Advertising,” and to be retained by the law firm for a period of not less than three years in the case of hard copies and one year for computer accessible communications. See, RPC 7.1(f), (k). RPC 7.1 underwent a revision by the Appellate Division following the Second Circuit’s 2010 decision in *Alexander v. Cahill*, 598 F.3d 79 (2d Cir. 2010), which found that certain aspects of the predecessor rule were unconstitutional regulation of commercial speech. The rule now provides guidance on the details of permissible lawyer advertising, a full exposition of which is beyond the scope of this article.

The definition of an advertisement is significant. According to the definitions section of the Rules of Professional Conduct, an advertisement is “any public or private communication made by or on behalf of a lawyer or law firm about that lawyer or law firm’s services,

the primary purpose of which is for the retention of the lawyer or law firm.” (RPC 1.0(a).) The rule explicitly excludes from its definition communications with existing clients or other lawyers. The New York State Bar Association commentary adds the gloss that advertising should be narrowly defined as limited to communications whose primary purpose is “retention of the lawyer or law firm for pecuniary gain...”<sup>‡</sup> The “pecuniary gain” factor is not found in the text of the rule itself.

So, how do we ascertain the primary purpose of a lawyer’s communication, and whether the communication is seeking the retention of the lawyer or something else? Some explanation is provided by the NYSBA commentary, which states that “communications to other lawyers, including those made in bar association publications and other publications targeted primarily at lawyers, are excluded from the special rules governing lawyer advertising even if their purpose is the retention of the lawyer or the law firm.”<sup>§</sup> Similarly, topical newsletters, client alerts, or blogs intended to educate recipients about new developments in the law generally are not considered advertising\*\*.

On the other hand, client alerts or blogs that provide information or news primarily about the lawyer or law firm “generally would be considered advertising.”<sup>††</sup> Even if a lawyer does not prepare a communication herself, it could be considered attorney advertising to forward or disseminate a favorable article about the lawyer’s services written by a third party.<sup>‡‡</sup> However, simply describing the lawyer’s charitable or educational works would be considered mere branding, not advertising.

Also generally excluded from the definition of advertising would be a lawyer's participation in an educational program "because its primary purpose is to educate and inform rather than attract clients."<sup>§§</sup> However, an educational program might be found to cross the line and constitute advertising if the participants were actively encouraged to retain the lawyer. The NYSBA commentary indicates that a lawyer's participation in and promotion of cultural, sporting, and charitable events generally are not considered advertising. Nor would a lawyer's dissemination of law firm giveaways, such as complimentary pencils or coffee cups, be considered advertising. Rather, such marketing swag ordinarily would be considered as enhancing the firm's brand, not directly seeking retention of the lawyer.

How do these rules apply to social media? In its 2015 Opinion 748, the New York County Lawyers Association Professional Ethics Committee (of which the author is a member) acknowledged that the definition of attorney advertising is restricted to communications about the lawyer or the law firm's services, the primary purpose of which is retention of the lawyer for pecuniary gain.<sup>\*\*</sup> According to NYCLA Ethics Opinion 748, a LinkedIn profile that contains only biographical information, such as education and work history, would not qualify as an attorney advertisement within the meaning of RPC 7.1. Nor did the NYCLA Committee find that filling out the fields of skills, endorsements, or recommendations on LinkedIn would constitute a violation of RPC 7.4, which prohibits an attorney from identifying herself as a specialist without appropriate advanced certification from a recognized national accreditation authority.

While profiles containing lawyers' background information would not be considered advertising, the NYCLA Committee took the position that a profile including "subjective statements regarding an attorney's skills, area of practice, endorsements and testimonials from clients or colleagues is likely to be considered advertising."<sup>+++</sup> The NYCLA Committee reminded lawyers that in the event that advertisements were reasonably likely to create an expectation of results, or compared the lawyer's services with those of other lawyers, the attorney should label the page as "Attorney advertising" and include the disclaimer

"Prior results do not guarantee a similar outcome."

The NYCLA Committee cautioned that New York lawyers must periodically monitor and review the endorsements on their social media pages. In the case of third-party external endorsements on lawyers' LinkedIn profiles — for example, an endorsement by a colleague or client — lawyers have an ongoing obligation to review social networking sites at reasonable intervals to confirm their accuracy and ensure that their LinkedIn profiles do not contain skills and endorsements to which they cannot honestly lay claim. For example, a matrimonial lawyer who is the recipient of an unrequested endorsement for her skills in patent law should delete any undeserved praise for legal experience she patently lacks.

The New York City Bar, in its December 2015 Opinion 2015-7, rejected a bright line test for determining what qualifies as attorney advertising on social media, and instead reminded New York lawyers that the definition of advertising in RPC 1.0 depends (as also indicated in the NYCLA opinion) on "the primary purpose for the retention of the lawyer or law firm."<sup>+++</sup> After a detailed analysis of prior ethics opinions on the definition of advertising, the City Bar Committee determined that a LinkedIn profile would constitute attorney advertising only if it had for its primary purpose the retention of the lawyer for pecuniary gain, which the City Bar Committee determined was based on the "subjective intent of the lawyer who makes the communication. . . ."<sup>§§§</sup>

The City Bar also cautioned that not all LinkedIn communications are made for the primary purpose of retention for pecuniary gain and listed several other potential motivations, including networking with college and law school classmates, keeping track of career developments of friends and colleagues, publishing and sharing articles, looking for jobs, maintaining a digital resume, and enhancing the lawyer's brand. For instance, the attorney advertising rule would not apply to a lawyer in government service or academia, working for a non-profit, or trolling for pro-bono assignments.

The City Bar articulated a five-step analysis to determine whether a LinkedIn profile would constitute attorney advertising. A communication is not advertising unless: (a) it is made by or on behalf of the lawyer; (b) its primary purpose is to attract new clients for pecuniary gain; (c) the contents relate to the lawyers' legal services; (d) the contents are intended to be viewed by potential new clients; (e) there is no recognized exception under the Rules of Professional Conduct, e.g., for communications to other lawyers or existing clients. Under the City Bar's analysis, content relating to the lawyer's skills or practice areas, assuming it meets the other criteria in its definition, would constitute an advertisement. The City Bar provides the example of a lawyer is displaying an endorsement for litigation, matrimonial or appeals as constituting advertising. On the other hand, according to the City Bar, an endorsement for writing, public speaking, or technology would not necessarily relate to the lawyer's legal services, nor would a recommendation describing a lawyer's commitment to public service, social justice or volunteering be considered advertising.

Both bar associations agreed that the advertising rule would not apply to communications directed to other lawyers, communications not intended to result primarily in the retention of the lawyer or law firm, or communications to existing clients.

## Conclusion

The City Bar and NYCLA have disagreed on several topics, with NYCLA adopting a bright-line test and the City Bar taking a more complicated and confusing approach that provides little guidance for ordinary practitioners. However, the two New York bar associations agree on several major areas relating to advertising on social media. Not all communications on LinkedIn are considered advertising. Routine

biographical and education information, along with basic marketing and branding of the law firm, generally would not be considered attorney advertising and would not subject to labeling as such or the one-year retention requirements set forth in RPC 7.1. On the other hand, a detailed description of a lawyer's legal skills with intent to garner retention for pecuniary gain would be likely to constitute attorney advertising and should be labeled as such and retained for the relevant period.

Moreover, law firms with offices in other states should be mindful of potentially additional requirements in those jurisdictions. A comparison of New York advertising rules with those of other jurisdictions is beyond the scope of this article.

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† [www.nycla.org/ethics](http://www.nycla.org/ethics)

† [www.nycbar.org/members/formal-opinion-2015-7-application](http://www.nycbar.org/members/formal-opinion-2015-7-application)

‡ RPC 7.1 Comment [6]

\*\* RPC 7.1 comment [7]

§ RPC 7.1 comment [7]

†† RPC 7.1 comment [7]

‡‡ RPC 7.1 [8]

§§ RPC 7.1 Comment [9]

\*\*\* NYCLA eth.op.748, [www.nycla.org/ethics](http://www.nycla.org/ethics)

††† NYCLA eth. op. 748 at 5

‡‡‡ NYCBA eth. op. 2015-7

§§§ NYCBA eth. op. 2015-7

# The New Cyber Threat — Business Interruption Exposure

By: Costantino P. Suriano and Bruce R. Kaliner

As more businesses come to realize that cyber attacks pose a serious threat to business operations, revenue streams, and contingency planning, the market is starting to expand and develop new products to address business interruption (“BI”) resulting from a cyber attack<sup>1</sup>. Some of the more common cyber attacks against businesses include denial-of-service, brute force (to obtain passwords), insertion of malware or malicious code, ransomware, backdoor attacks, and social engineering. This article provides a primer for underwriters and claims professionals on the issues that may arise when the traditional concept of first-party BI coverage is married to cyber coverage.

BI coverage is a time element coverage offered under first-party property policies. In the first-party context, there must be direct physical loss or damage by a covered cause of loss that causes a necessary interruption of the insured’s operations (either wholly or partially as specified in the policy<sup>2</sup>). Once these conditions are met, the actual loss sustained is measured to determine the loss of business income from the interruption.

It is important to remember that first-party property policies do not traditionally extend property loss or damage to electronic data, as such data is not considered a physical or tangible object subject to loss or damage. When BI coverage is offered under cyber policies, the direct physical loss or damage requirement may be substituted with an electronic data driven event — a specified type of cyber attack.


The scope and elements of what constitutes a cyber attack in the policy is therefore of critical importance. In other words, what triggers BI coverage for a network attack? As noted above, BI coverage originally was intended for physical loss and is now being imported into the ethereal and nonphysical world.

As part of a triggering event for BI coverage, there must be a direct causal connection between the

cyber attack and the interruption of business and loss of revenue. For an active attack, where an adversary or perpetrator destroys or alters data that crashes a computer system or service is denied and business operations cease, the causal connection to any business loss should be fairly straightforward to establish. However, the causal connection is less clear in a situation involving a passive network attack, when a computer system is infiltrated but the perpetrator is only gathering data or exploring the system, and no data is disturbed, altered or destroyed. In such a situation, a network attack has occurred and remedial measures are necessary, but computer operations may continue uninterrupted while the security of the system is being restored and any malicious software is neutralized. Although the cyber policy may respond and pay for expenses to restore the network security under other coverages, a BI loss has not been established because there was no interruption of operations.

Another scenario could involve a passive attack combined with a public disclosure that an insured’s network has been compromised. In that situation, daily business operations would continue unhindered but there might be a loss of customers and revenue resulting from security concerns. On the one hand, the network attack took place and the loss of network security is driving away customers, and the insured is likely to contend that network security is an intrinsic service that it provides to customers. On the other hand, relying on traditional concepts of BI coverage, there would be no complete or even partial suspension of the insured’s network operations. The loss of revenue would be based on customers’ decisions and there is no causal connection between the suspension/interruption of operations and the loss of revenue. Additionally, if the customer no longer wants the insured’s services, that may also be a “loss of market” situation, which is normally excluded in BI policies.





There are countless cyber attack situations that can arise. Therefore, when a cyber attack claim is presented and adjusted, the policy wording and the triggering events, as well as the causal relationship of the network attack to the revenue loss, must be examined closely. At times, it may be a challenge to correlate which incurred costs are associated with the covered event versus non-covered costs, such as permanent upgrade to network security. Adding to the complexity of analyzing a cyber BI claim is the insurer's reliance on the insured's cooperation in openly sharing what exactly took place in its system and how these compromised systems tie into its operations and revenue stream(s).

As part of BI coverage, the extent of financial reimbursement for a covered revenue loss is also controlled by other important policy provisions:

- The specified BI sublimit in the policy will set forth the maximum BI exposure for the insurer. Regardless of the revenue loss, the BI sublimit caps the payout under the policy. The BI sublimit may at times be tied to an annual BI aggregate limit — the maximum payable in the policy period if separate network attacks take place.
- Policies that provide BI coverage will often include a separate BI deductible or BI waiting period (either in hours or days) before liability will arise under the policy. If a BI loss is below the deductible or does not exceed the waiting period, then the policy will not respond. An example of the waiting period not being met would be if a denial-of-service lasts two hours and the waiting period is four hours.
- BI policies will also provide that liability is only for the specified period of restoration. This period is usually a defined period and requires the insured to use due diligence and dispatch to resume its operations.
- BI coverage for network attacks is usually restricted by excepting certain types of costs

that are not covered. Costs that are not covered can include third-party liability, contractual liability, fines and penalties, and upgrades for the restoration of network security.

- In addition to certain types of non-covered costs, there will be certain BI exclusions, including idle periods (when the insured is not in operation for other reasons), consequential loss, or loss of market. In addition, cyber policies typically exclude loss by insured perils under a first-party property policy, such as fire, smoke, explosion, earthquake, etc., as these physical perils are not the intended risk being insured. Service interruption of utilities is also commonly excluded.

\* \* \* \*

Unlike other types of insurance, BI coverage is more nuanced in that overlapping conditions must be examined as part of the determination of whether a BI claim is compensable. The starting point for making such an analysis is a comprehensive understanding of the cyber attack that took place, what was affected and its impact on operations, along with a careful reading of the policy.

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1. Extra Expense coverage (i.e. costs an insured expends to reduce its loss that would not be incurred except for the loss taking place) is often offered in conjunction with BI coverage. Extra Expense is sometimes considered to fall under time element coverage. Other time element coverage can include contingent business interruption, service interruption, and interruption by civil or military authority.

2. The two usual options are whole (complete) or partial. When partial is provided, this necessarily provides broader coverage to the insured as the loss does not need to shut down the insured's entire business operations.



## In New York, Do Pervasive Odors Constitute An Occurrence Causing Property Damage?

By: Costantino P. Suriano and Daniel Markewich

This article addresses whether, under New York law, a commercial general liability insurer would be liable for its insured's breach of contract if the insured botches a building renovation resulting in foul odors permeating the building so much so that tenants move out and stop paying rent. To predict how a New York court would rule on this issue, it is necessary to examine both third-party liability and first-party property decisions in New York and in other jurisdictions.

### Third-Party Liability Coverage

Under New York Law, an "occurrence" does not include claims for mere faulty workmanship of the insured but rather, only for consequential third-party damage resulting from the insured's activity. *J.Z.G. Resources, Inc. v. King*, 987 F.2d 98, 102 (2d Cir. 1993). While New York courts generally acknowledge that a CGL policy does not insure for damage to the work product itself, the courts hold that a CGL Policy does insure "faulty workmanship in the work product which creates a legal liability by causing bodily injury or property damage to something other than the work product." *George A. Fuller Co. v. U.S. Fid. & Guar. Co.*, 613 N.Y.S.2d 152, 155 (1st Dep't 1994); *Aquatectonics, Inc. v. The Hartford Cas. Ins. Co.*, 2012 WL 1020313 (E.D.N.Y. Mar. 26, 2012).

Let us assume the building owner can show that its contractor (the insured) failed to install insulation in strict accordance with manufacturer

specifications, which resulted in pervasive odor from the insulation throughout the building's carpet and ceiling tiles and required the replacement of the tiles and the temporary relocation of tenants temporarily to vacate the premises. Under established case law, there would be no coverage under a CGL policy for the insured's faulty installation of the insulation.

However, assuming the bad odor emanating from the faulty insulation caused "property damage" to something other than the insured's work, is there an "occurrence" that will "trigger" coverage under the policy? Further, assuming an "occurrence," is there also CGL coverage for the building's air testing and purification expenses? Yes to all, according to *Essex Ins. Co. v. BloomSouth Flooring Corp.*, 562 F.3d 399, 406 (1st Cir. 2009), a First Circuit decision that was one of the earliest cases — and thus far the only significant third-party coverage case — finding an occurrence and property damage from pervasive odors.

Many CGL policies broadly define property damage as both physical injury to tangible property and loss of use of tangible property that is not physically injured. As in our hypothetical, Essex involved a coverage dispute between the insurer, Essex, and its insured contractor, BloomSouth, in relation to a faulty workmanship claim. The CGL policy defined "property damage" as "[p]hysical injury to tangible property,

including all resulting loss of use of that property,” and “[l]oss of use of the work” for which it was hired. BloomSouth installed a carpet at the premises. Sometime thereafter, the occupants noticed an offensive odor that caused some of the occupants to become ill. The First Circuit held that the odor permeating the premises from the installation of new carpeting constituted physical injury to the building when it rendered the building unusable.

### First-Party Liability Coverage

To date, no reported New York decision – either first- or third-party – has held that permeating odors constitute property damage. The Appellate Division, Fourth Department came fairly close in 1988 when it held in a third-party case that the physical properties of gases escaping from the installation of foam insulation caused property damage to vapor barriers and the roof membrane of a building. *Apache Foam Prods. Div. v. Continental Ins. Co.*, 528 N.Y.S.2d 448 (4<sup>th</sup> Dep’t 1988). Until recent years, only a few scattered cases from around the country held that permeating odors could cause property damage. Today, the case law may be changing but likely only in the first-party arena.

### Cases Finding No Coverage

As recently as 2012, the Sixth Circuit held firmly to a no coverage position relative to claims involving odors. In *Universal Image Productions, Inc. v. Fed. Ins. Co.*, 475 Fed. App’x 569, 575 (6<sup>th</sup> Cir. 2012), the insured attempted to recover for mold and bacteria contamination. The court observed that, unlike in *Essex*, there was no

evidence that the odor in the case before it permeated the entire building; rather, it was confined to one floor. The court considered the insured’s “damage” as intangible harms, such as pervasive odor, mold and bacterial contamination, and water damage. Ultimately, the court opined that these types of harms did not constitute physical loss. The Sixth Circuit cited to *De Laurentis v. United Servs. Auto. Ass’n*, 162 S.W.3d 714, 716 (Tex. Ct. App. 2005), to determine whether mold constitutes “direct physical loss.” In that case, the insured submitted a claim for mold damage requiring the remediation of her furniture and personal property. The insurer denied the claim, asserting that mold damage did not constitute “physical loss.” The Texas court relied on dictionary definitions, holding that a “physical loss” is “simply one that relates to natural or material things.”

However, the policy language in both *De Laurentis* and *Universal* is different from several more recent iterations of CGL wordings. The court in *Universal* relied heavily on the property policy’s “direct physical loss” requirement as contrasted with the CGL policy requirement of “[p]hysical injury to tangible property.” Additionally, the court noted that even if its *De Laurentis* analysis was not on point, the presence of mold at the insured’s premises did not force people to leave the premises, nor it did it extend beyond a narrow area. In contrast, in our hypothetical there may be a different conclusion, given the CGL policy wording and the presence of a more severe odor that permeated other portions of the owner’s premises and forced tenants from the damaged area.



Other courts likewise have continued to opt for relatively narrow definitions of “physical damage.” In *Advanced Cable Co. v. Cincinnati Ins. Co.*, No.13-cv229, 2014 WL 975580 (W.D. Wis. June 20, 2014), the court analyzed whether cosmetic hail damage to a roof constituted physical damage and cited to *Couch on Insurance* in defining physical damage. The court noted, “[a]s with any insurance, property insurance coverage is ‘triggered’ by some threshold concept of injury to the insured property. . . . In modern policies, especially of the all-risk type, this trigger is frequently ‘physical loss or damage,’ but may be any of several variants focusing on ‘injury,’ ‘damage,’ and the like. . . . There is little question this threshold has been met when an item of tangible property has been physically altered by perils like fire, or water.” 10A *Couch on Insurance* § 148:46 (3d ed. 2013), available at Westlaw COUCH; accord, e.g., *Port Auth. of N.Y. and N.J. v. Affiliated FM Ins. Co.*, 311 F.3d 226, 235 (3d Cir. 2002) (“[i]n ordinary parlance and widely accepted definition, physical damage to property means ‘a distinct, demonstrable, and physical alteration’ of its structure”). The court ultimately concluded that minor cosmetic hail damage constituted “direct physical loss,” thereby triggering coverage. While *Advanced Cable* and *Port Authority* were both discussing relatively clear physical damage to the property, the decisions illuminate that some courts still adopt a more literal interpretation of “physical.”

### Cases Finding Coverage


While *Essex* is the only CGL case of significance to have found insurance

coverage for such a claim, a number of first-party cases after 2009 have reached a similar conclusion. In *Travco Ins. Co. v. Ward*, 715 F. Supp. 2d 699 (E.D. Va. 2010), the insured sought coverage under his homeowners policy for damages allegedly caused by defective drywall that released sulfuric gas. The suit alleged that the drywall in his home “emits various sulfide gasses and/or other toxic chemicals . . . that create noxious odors and cause damage and corrosion.”

Although the *Travco* policy did not define the term “direct physical loss,” it defined “property damage” as “physical injury to, destruction of, or loss of use of tangible physical property.” The insurer argued there was no direct physical damage because such a loss requires some physical alteration or injury to the property’s structure, and the drywall itself remained “physically intact, functional and has no visible damage.” The insured argued that there had been “property damage” and, thus, direct physical loss, because he was forced to leave his residence as a result of the noxious odors. The *Travco* court ultimately sided with the insured, finding that the insured’s home was rendered uninhabitable by the toxic gases released by the drywall and, accordingly, the property had sustained direct physical loss or damage. The court’s conclusion that the insured had suffered a direct physical loss was strengthened by the fact that the policy specifically defined “property damage” to include “loss of use of tangible property,” which is similar to the language found in *Essex* and many current policies.

The 2014 first-party decision in





*Newman Myers Kreines Gross Harris v. Great Northern Ins. Co.*, 17 F. Supp. 3d 323 (S.D.N.Y. 2014), provides some insight into how a New York federal court might view a claim for “direct physical loss or damage” resulting from odors or fumes. In *Newman Myers*, the sole issue was whether the insured’s claim for loss of business income and expenses suffered as a result of a power outage brought about by Superstorm Sandy constituted “direct physical loss or damage” under its property policy. Although this claim did not involve an odor, the insured relied on several out-of-state decisions holding that the presence of odors, fumes, or noxious gases in a workplace was “direct physical loss or damage” because the property was rendered unusable or unsatisfactory for its intended purpose. The court reasoned that, although these cases did not involve tangible, structural damage to the architecture of the premises, in each case there was some compromise to the physical integrity of the workplace. Critical to the court’s analysis, however, was that the policy term at issue, requiring “physical loss or damage,” did not require that the damage be tangible, structural, or even visible. The *Newman Myers* court felt that the invasions of noxious or toxic gases in two of the cases rendered the premises unusable or uninhabitable because “invisible fumes can represent a form of physical damage.” *Newman Myers* grounded its reasoning in both the first-party *Travco* case and the third-party *Essex* case.

Later in 2014, the New Jersey federal district court decided *Gregory Packaging, Inc. v. Travelers Prop. Cas. Co. of Am.*, Civ. No. 2:12-cv-04418 (WHW), 2014 WL 6675934 (D.N.J. Nov. 25, 2014), another first-party case. The court concluded that under New Jersey law the release of ammonia “physically transformed the air” in the facility, rendering it “unfit for occupancy until the ammonia could be dissipated.” The court then held that the ammonia discharge constituted physical loss under Georgia law, because it “physically changed the facility’s condition to an unsatisfactory state needing repair.”

Only a year ago, the New Hampshire Supreme Court opined on the issue of whether pervasive odor constituted an occurrence. In *Mellin v. Northern*

*Sec. Ins. Co., Inc.*, 115 A.3d 799 (N.H. 2015), a first-party case, the insureds sued for the loss of use of their apartment from cat urine odor emanating from a neighboring apartment. The insureds argued that they were entitled to coverage because “physical loss” includes pervasive odors. The court rejected the insurer’s argument that a physical loss requires “tangible alteration to the appearance, color, or shape” of the covered apartment. Alternatively, the court opined that “physical loss need not be read to include only tangible changes to property that can be seen or touched, but can also encompass changes that are perceived by the sense of smell.” The New Hampshire court relied in part on *Gregory Packaging*.

The most recent decision on this issue is only a few months old, *Or. Shakespeare Festival Ass’n v. Great Am. Ins. Co.*, Civ. No. 1:15-cv-01932-CL, 2016 WL 3267247 (D. Or. June. 7, 2016). *Shakespeare Festival* is a first-party case in which the insured sought coverage for loss and damage to its concert venue when smoke from a nearby wildfire filled its theatre, causing the insured to cancel performances and lose business income. The insured argued that it should recover because the smoke caused harm to the interior of the theatre, including the inside air.

The court rejected the insurer’s argument that the damage must be physical, opining that “certainly, air is not mental or emotional, nor is it theoretical.” The court relied on many of the cases discussed above in concluding that a pervasive odor caused physical damage. It noted that wildfire smoke entered the interior of the theatre, making it uninhabitable and unusable for holding performances. Similar to a home tainted by methamphetamine odor as in an earlier Oregon state case, or a facility overcome with ammonia as in *Gregory Packaging*, the smoke-filled theatre was “unusable for its intended purpose.” See *Farmers Ins. Co. of Or. v. Trutanich*, 123 Or. App. 6, 858 P.2d 1332, 1336 (1993) (cost of removing odor from methamphetamine lab constituted direct physical loss). The court concluded that the theatre sustained “physical loss or damage to the property” when the smoke rendered the premises unusable for its intended purpose.



*Shakespeare Festival* provides further insight into the classification of non-dangerous odors. While methamphetamine and ammonia odors arguably provide an immediately dangerous environment for persons in close proximity, the Oregon district court did not focus on the potential danger from the smoke. Rather, the court stressed the inability to use the premises as expected due to the odor's permeation of the covered property. In addition, *Shakespeare Festival* rejected the insurer's argument that the smoke might fall under the pollution exclusion in the policy, holding that wildfire smoke did not fall under the exclusion because "wildfire" clearly was omitted from the policy.

Similarly, in *Pepsico, Inc. v. Winterthur Int'l Am. Ins. Co.*, 788 N.Y.S.2d 142, 144 (2d Dep't 2004), New York's Appellate Division failed to extend the pollution exclusion beyond the exact wording of the policy, concluding that the exclusion did not apply to losses that were "non-environmental in nature."

In our hypothetical, the insurer would likely have a similarly difficult time in claiming a pollution exclusion unless the exclusion language in the policy specifically addressed the type of pervasive odor caused by the insured's faulty workmanship. Under both *Shakespeare Festival* and *Pepsico*, a pollution exclusion defense would be unlikely to prevail.

## Conclusion

We again note that none of the decisions discussed herein other than *Essex* – the earliest, from 2009 – concerns third-party coverage, and all are from out of state. Nevertheless, pervasive odors seem to be attracting substantial coverage in the courts, so beware and use those breathing masks!

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# The New York Department of Financial Services Cybersecurity Regulations: An Update For Lawyers Representing Financial Institutions

By: Barry R. Temkin

Lawyers who represent insurance companies, banks, insurance agents, and other financial institutions in New York should be aware of new Department of Financial Services cybersecurity regulations that become effective January 1, 2017. The new DFS cybersecurity regulations require covered entities, including insurance companies, mortgage brokers, insurance agents and banks, to appoint a Chief Information Security Officer (CISO) and to develop a comprehensive cybersecurity program in order to prevent hacking and other data breaches.<sup>1</sup> In addition, the new DFS regulations will require the filing of an annual cybersecurity report, which must explain the state of the company's compliance with the new regulations, identify any soft spots or potential areas for improvement, and be signed and certified by the company's board chair or CEO.<sup>2</sup> The new regulations are codified at 23 NYCRR §500.0 *et seq.* and can be found at the DFS website <http://www.dfs.ny.gov/legal/regulations/proposed/rp500t.pdf>. This article will explain the new DFS regulations as proposed at the time of writing, and discuss their implications for law firms that represent financial institutions doing business in New York. Since the cybersecurity regulations are subject to a 45-day commentary period, there is a possibility that they could be subject to further revisions by the time of implementation.

The news abounds with almost daily reports of hacking and other cybersecurity breaches. Professional liability insurers estimate that many of the largest U.S. law firms have experienced hacking or other forms of data breaches recently. Nor is external hacking the only threat faced by law firms. Numerous data breaches may be attributable to mere negligence, such as a law firm employee's leaving a laptop, cell phone, or other electronic device in a taxi, coffee shop, or other public place. Moreover, information stored in the cloud, or transmitted via an

unsecured server, may be vulnerable or unsecured. In 2016, there were several press reports of law firms being hacked, including Cravath, Swaine & Moore and Weil Gotshal & Manges.<sup>3</sup> A data breach of Panamanian financial law firm Mossack Fonseca made international headlines, embarrassing the firm's roster of affluent and politically powerful clients with the unauthorized release of the so-called "Panama Papers."<sup>4</sup> With clients coming to expect their law firms and other vendors to safeguard and encrypt confidential information, the organized bar is not far behind.

## The New DFS Cybersecurity Regulations

The new DFS cybersecurity regulations apply to "any Person operating under or required to operate under a license, registration, charter, certificate, permit, accreditation, or similar authorization under the banking law, the insurance law or the financial services law."<sup>5</sup> Among other covered entities, DFS exercises jurisdiction over banks, insurance companies, charitable foundations, holding companies, mortgage brokers, mortgage loan originators, insurance agents, and premium finance agencies. A limited exception to the regulations is carved out for otherwise covered entities with fewer than 1000 customers, less than \$5 million in gross annual revenue, and less than \$10 million in year-end total assets. The Rules provide for a 180-day transitional period to comply with their requirements.

Encryption is a key part of the new regulations, which require each covered entity to "encrypt all non-public information held or transmitted by the covered entity both in transit and at rest."<sup>6</sup> Non-public information that could not be feasibly encrypted must be secured with additional or alternative controls. The DFS regulations require encryption of "nonpublic information," which includes personal identification

information (PII), competitively sensitive information and any information that would be considered nonpublic under the Gramm-Leach Bliley Act of 1999. The encryption requirement is set forth in Section 500.15, which provides as follows:

(a) As part of its cybersecurity program, each Covered Entity shall encrypt all Nonpublic Information held or transmitted by the Covered Entity both in transit and at rest.

(b) To the extent encryption of Nonpublic Information in transit is currently infeasible, Covered Entities may instead secure such Nonpublic Information using appropriate alternative compensating controls reviewed and approved by the Covered Entity's CISO. Such compensating controls shall not be used in lieu of meeting the requirements of subsection 500.15(a) after one year from the date this regulation becomes effective.<sup>7</sup>

Thus, encryption of sensitive data is now required for nonpublic information. However, the encryption requirement is delayed until one year from the effective date of the regulation.

The DFS encryption requirement is part of a growing national trend pioneered by Massachusetts with its data protection law. See, Mass. Gen. L. Ch. 93H, 201 C.M.R. 17 (requiring the encryption of personal information stored on portable devices and personal information transmitted across public networks or wirelessly).

Under the proposed regulations, each firm must appoint a Chief Information Security Officer who reports to the board of directors and is required to prepare an annual report setting forth the nature of the registrant's cybersecurity program, any risks or challenges identified by the CISO, and proposed steps to remediate any identified problems. In addition, the regulated entity must prepare a written incident response plan designed to respond to and recover from a potential data breach. The registrant must notify the superintendent of DFS within 72 hours in the event of a known material data breach.

The new regulations also propose "limitations on data retention" mandating the destruction of non-public information that is no longer necessary. This requirement could place these regulations in potential conflict with a body of case law about electronically-stored information, spoliation, and maintenance of electronically stored data as required by financial industry regulations and court rules.

### **Implications for Law Firms**

Lawyers who represent regulated financial service companies in New York, including banks, insurance agents, and insurance companies, should familiarize themselves with these regulations. Significantly, the new DFS regulations would look not only to the registrants, but also to third-party vendors with which they do business. According to Section 500.11 of the new DFS regulations:

(a) Third Party Information Security Policy. Each Covered Entity shall implement written policies and procedures designed to ensure the security of Information Systems and Nonpublic Information that are accessible to, or held by, third parties doing business with the Covered Entity. Such policies and procedures shall address, at a minimum, the following areas:

(1) the identification and risk assessment of third parties with access to such Information Systems or such Nonpublic Information;


(2) minimum cybersecurity practices required to be met by such third parties in order for them to do business with the Covered Entity;

(3) due diligence processes used to evaluate the adequacy of cybersecurity practices of such third parties; and

(4) periodic assessment, at least annually, of such third parties and the continued adequacy of their cybersecurity practices.

Thus, financial companies doing business with





vendors such as law firms will be required to affirm that these vendors maintain minimum cybersecurity practices, including, ultimately, encryption of electronic data. Accordingly, law firms that represent covered entities, including insurance companies and banks, should ensure that their information technology systems — including email — are appropriately encrypted as well. No lawyer would want to be responsible for a client's violation of a DFS regulation.

Recent ethics opinions, most notably in California, have suggested that lawyers have ethical duties to familiarize themselves with and ensure literacy with their clients' electronic storage systems, particularly in the context of litigation involving electronically stored information. See, California Standing Committee on Professional Responsibility and Conduct Formal Op. 2015-193 (attorney lacking the required e-discovery competence must either acquire the requisite skill and technical expertise in e-discovery, associate with technical consultants or competent counsel, or decline the representation). Other recent opinions have agreed that lawyers should act diligently to maintain the confidentiality of electronically stored client data. Indeed, some jurisdictions have begun imposing requirements that lawyers undergo mandatory continuing legal education in technology and electronic data skills. See, Florida Rules of Professional Conduct, Rule 6-10.3(b) (imposing three credit hours of mandatory CLE training in approved technology programs).

## Conclusion

Lawyers representing financial institutions should be sure to engage appropriate encryption technology. The trend among ethics committees and regulators suggests that lawyers have an ongoing obligation to become cognizant of new developments in technology and to take reasonable steps to prevent data breaches. While lawyers may tend to be less tech-savvy than their clients, lawyers who fail to keep up with the times could conceivably find themselves left in the dust, as regulated clients move on to engage law firms that are willing to undertake the investment necessary to keep up with cybersecurity technology.

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1. See New York DFS Proposed Regulations, <http://www.dfs.ny.gov/legal/regulations/proposed/rp500t.pdf>
2. See 23 NYCRR Section 500.09, <http://www.dfs.ny.gov/legal/regulations/proposed/rp500t.pdf>.
3. Nicole Hong and Robin Sidel, Hackers Breach Law Firms, Including Cravath and Weil Gotshall, The Wall Street Journal, March 29, 2016, <http://www.wsj.com/articles/hackers-breach-cravath-swaine-other-big-law-firms-1459293504>.
4. Frances Ivens, Panama Papers Put Spotlight on Law Firm Data Security, The American Lawyer, April 4, 2016, <http://www.americanlawyer.com/id=1202753986288/Panama-Papers-Put-Spotlight-on-Law-Firm-Data-Security?slreturn=20161109122347>.
5. See 23 NYCRR Section 500.01 (c).
6. 23 NYCRR Section 500.15, <http://www.dfs.ny.gov/legal/regulations/proposed/rp500t.pdf>.
7. 23 NYCRR Section 500.15, <http://www.dfs.ny.gov/legal/regulations/proposed/rp500t.pdf>.



## Undertakings

By: Costantino P. Suriano and Daniel Markewich

“Undertaking.” What does that mean in the liability trial context? Perhaps most practitioners do not have to worry about the vagaries of the appellate process. At times, however, even the trial lawyer is required to understand the basics of what some courts call an “appeal bond” (but what New York courts call an “undertaking”).

This article considers a hypothetical New York lawsuit where a liability insurer has defended the insured in an action where the judgment does not exceed the policy limits but the insurer has a sound basis – though not yet a judicial declaration in its favor – for asserting that part of the judgment is excluded from coverage. In these circumstances, it is necessary to determine whether the insurer can obtain a stay of enforcement pending appeal without a court order by filing an undertaking pursuant to CPLR 5519(a) (2) in the full amount of the judgment against the insured. This situation frequently arises in circumstances such as those discussed in *Prashker v. U.S. Guar. Co.*, 1 N.Y.2d 584 (1956), where the insurer has reserved its rights but must await the outcome of the liability trial before seeking a declaratory judgment apportioning the result between its insured and uninsured parts.

According to 12 Weinstein-Korn-Miller 2d, *N.Y. Civ. Practice CPLR*, sec. 5519.11, “the standard liability policy provides that the insurer will pay the cost of an appeal bond to secure a judgment up to the limits of

the policy” and thereby obtain a stay of enforcement pending appeal. This analysis of the “standard” New York CGL policy may be more problematic than when written fifty years ago, but it tracks a separate CPLR provision, sec. 5519(b), under which an insurer whose policy limit “is less than the amount of [the] judgment” can obtain a stay of enforcement of the insurer’s portion of the judgment without court order by filing an undertaking to the extent of its limits, leaving it up to the insured to give an undertaking for the balance of the judgment.

It is tempting to posit that, because the insurer is obliged by CPLR 5519(b) to provide an undertaking only to the extent of the insurer’s policy limit, when the judgment exceeds such limit that the insurer similarly is required to provide an undertaking only to the extent of the policy coverage when the limits have not been reached but part of the judgment is excluded from coverage. This analogy, however, presents various problems under New York law.

All the New York commentaries and cases concur that the better practice is to post a full undertaking. *Timal v. Kiamzon*, 164 Misc. 2d 159, 162 (Qu. Sup. Ct. 1995), holds that where “there is no claim by the insurer that the claim exceeds the policy limits, CPLR 5519(b) is inapplicable, and CPLR 5519(a) controls.” *Maharan v. Berkshire Life Ins. Co.*, 948 F. Supp. 261, 262, 263 (W.D.N.Y. 1996), comments: “When the amount of the judgment does not

exceed the value of the policy, section 5519(a)(2) applies,” and requires that an undertaking be posted “in the full amount of the judgment.” See also Siegel, *Practice Comm. C5519.2* to McKinney’s CPLR: “Under paragraph 2” of CPLR 5519(a), “involving the ordinary money judgment, the amount of the judgment fixes the amount of the undertaking.”

Only one commentator speaks to the extent of the insurer’s obligation under the current CGL policy form to pay for and secure an appellate undertaking of the type contemplated by CPLR 5519(a)(2) when a portion of the judgment appears to be excluded from coverage. In his 2005 A.B.A. presentation “Post Judgment Coverage Issues,” Texas attorney John Tollefson traced the evolution of the typical CGL Supplementary Payments wording from 1940 when it obligated the insurer “[to] furnish supersedeas and appeal bonds to stay all executions on all judgments, not in excess of the limits of liability of the Company under this policy,” to 1966 when the revised wording required the insurer to pay “all premiums on bonds to release attachments [and] all premiums on appeal bonds . . . but without any obligation to apply for or furnish any such bonds,” to 1996 when further revision mandated only that the insurer pay “the cost of bonds to release attachments, but only for bond amounts within the applicable limit of insurance. We do not have to furnish these bonds.” Although other portions of the CGL form have since undergone further modification, this 1996 language remains.

According to Tollefson, although “[c]

hanges in the form have steadily eroded the benefits provided,” courts and commentators have not considered “[w]hether the deletion of the reference to the term ‘appeal bond’ or ‘supersedeas bond’ is indicative of a deletion of this benefit.” Tollefson’s bottom line is that a “cost-benefit analysis” must be employed “when the carrier has defended under a reservation of rights, based on the belief that some, but not all damages are covered, and issues of coverage for all or part of the judgment remain after trial,” and “[t]he insurer must . . . weigh the strength of its coverage defenses against the damage to the insured that will be wrought by execution.”

Research in New York has uncovered no exception to the rule that, where the policy limits exceed the amount of the judgment, the insurer must file a full undertaking – even when the insurer has timely reserved its rights and can argue in good faith that a portion of the judgment is outside the policy’s coverage. Indeed, *Imber v. Consol. Indem. & Ins. Co.*, 147 Misc. 758 (App. T. 1st Dep’t), *aff’d*, 240 A.D. 820 (1st Dep’t 1933), *McDermott v. Concord Cas. & Sur. Co.*, 148 Misc. 323 (App. T. 1st Dep’t 1933), and *Materazzi v. Comm. Cas. Ins. Co.*, 157 Misc. 365 (N.Y. Sup. Ct.), *aff’d*, 248 A.D. 522 (1st Dep’t 1935), all hold that partial undertakings will not stay execution.

Suppose that, after considering the question, the insurer declines to provide an undertaking in excess of the portion of the judgment it believes is covered. Since no stay of execution on the judgment would be in effect because of the insurer’s failure to bond the entire judgment,



the judgment creditor would have the right under Insurance Law sec. 3420, thirty days after notice of entry, to file a direct action against the insurer for that portion of the judgment remaining unpaid. *Lang v. Hanover Ins. Co.*, 3 N.Y.3d 350 (2004).

Inasmuch as the insurer provided a complete defense to the insured at trial, the insurer could raise all of its coverage defenses in opposing the judgment creditor's lawsuit. *K2 Investment Grp., LLC v. Am. Guar. & Liab. Ins. Co.*, 21 N.Y.3d 384 (2013). So far, so good. But what if, before going after the insurer, the judgment creditor collected as much as it could from the insured, including portions of the judgment that indisputably were covered by the policy, and forced the insured out of business? Or what if the judgment creditor's collection efforts put the insured into bankruptcy for its inability to pay portions of the judgment that it turns out were covered by the insurer's policy? Is this a worthwhile risk for the insurer to take in lieu of bonding the entire judgment for appeal?

Even if the insured remains in business in the face of the judgment, cases such as *McDermott* and *E.M. Upton Cold Storage Co. v. Pacific Coast Cas. Co.*, 162 A.D. 842 (4th Dep't 1914), warn that the insurer that does not supply a full undertaking for a judgment falling under CPLR 5519(a) (2) may expose itself to the risk that, if an execution against the insured for the amount of the judgment exceeding the undertaking occurs before the appeal is decided, the insured too may sue the insurer and argue successfully that one consequence of the partial

execution against the insured was to damage or destroy its ability to conduct business.

On the other hand, the insurer also puts itself at risk by paying the full undertaking, as, according to *Smith v. 167th St. & Walton Ave. Corp.*, 177 Misc. 507, 509 (Bx. Sup. Ct. 1941), and *Kreitzer v. Chamikles*, 107 Misc. 2d 398, 399 (N.Y. Sup. Ct. 1980), the insurer thereby "relinquishes any defenses to liability it may have had under its policy and relies solely upon the errors assigned under the appeal."

Upon the reasoning of this line of cases, once the insurer has posted the full undertaking, it can no longer use coverage defenses to avoid paying the undertaking over to the judgment creditor on affirmance of the judgment. The insurer's only remedy in these circumstances will be to sue its insured in an effort to recoup that portion of the insurer's payment that is excluded from coverage – a dubious proposition at best.

Even outside the New York State courts, only two contemporary cases discuss the issue posed by this article. In *Wiegert-Stathes v. Am. Family Mut. Ins. Co.*, 2009 WL 3381578, \*7-8 (Neb. App. Oct. 20, 2009), decided under the 1996 policy wording, the court held that when the insurer's "policy limits are exhausted or 99 percent exhausted" and "virtually no coverage remained in comparison to the size of the judgment being appealed," the insurer is not required to post a supersedeas bond as, in such circumstances, the "bond would not be a defense cost, but, rather, an expansion of the policy limits."



But the Nebraska court also suggested, *id.* at \*7, that, as in the earlier case of *Johnson v. Maryland Cas. Co.*, 171 N.W. 908 (Neb. 1919), it would be proper to require the insurer to post a supersedeas bond as a “cost of defense” covered by the Supplementary Payments portion of the CGL policy “where the appealed judgment is less than the policy limits and the insured justifiably expects to be protected from levy while the adverse judgment is on appeal.” This analysis is certainly not helpful to the New York liability insurer.

The only other decision arguably on point is *Hatfield v. 96-100 Prince St., Inc.*, 972 F. Supp. 246, 247 (S.D.N.Y. 1997). In that matter, Judge Rakoff held that, because the policy did not require the insurer to post an undertaking and “most of the judgment from which plaintiff seeks to appeal relates to matters as to which the Court has already held there is no duty to defend, it would be grossly inequitable to impose such a requirement.” This holding has no obvious application to circumstances where the policy

may require the insurer to post the undertaking or the insurer is enjoined by the case law from commencing a declaratory judgment action prior to the outcome of the liability trial.

Accordingly, at least in New York, an insurer that is arguably required by its liability policy or case law to pay the cost of the undertaking to secure a judgment against its insured up to the policy limits acts at its own risk in failing to do just that – even if the insurer is convinced that parts of the judgment are excluded from coverage and has properly reserved its rights. At the same time, prudence would require that, during the appeal, the insurer commence a separate declaratory judgment action against its insured seeking confirmation that a portion of the judgment is not covered and requesting appropriate relief. Yes, another lawsuit!

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## Lawyers As Whistleblowers: Recent Developments

By: Barry R. Temkin

Several courts recently addressed the issue of whether lawyers may serve as whistleblowers against their former clients when doing so results in the disclosure of confidential client information. The Second Circuit, in *Fair Laboratory Practices Associates v. Quest Diagnostics*, held that a lawyer disclosed far more confidential information than was necessary when bringing a *qui tam* whistleblower case against a former client under the False Claims Act.<sup>1</sup> More recently, in a highly-publicized case against mutual fund giant Vanguard Group, a New York state court judge followed *Fair Laboratory Practices* to dismiss a *qui tam* claim brought by a terminated in-house tax lawyer under New York law.<sup>2</sup> A similar claim brought against Vanguard by the same lawyer was dismissed by a federal judge in the Eastern District of Pennsylvania, citing collateral estoppel grounds.<sup>3</sup>

These recent cases have important implications for employer liability. In addition, there could be potential professional liability for lawyers who are found to have breached their professional duties to their clients. A client could have a potential claim against a lawyer for precipitous disclosure of confidential information. Conversely, an employer who retaliates against a lawyer-whistleblower could face regulatory fines and civil liability. Moreover, a lawyer who accepts a whistleblower bounty from the government could potentially face a conflict of interest claim from an erstwhile client who contends that

its confidences were revealed in exchange for a government payout.

Lawyer and employer liability in the whistleblower context should be viewed against the backdrop of regulations promulgated by the SEC under the authority of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which authorize the payment of significant bounties to whistleblowers who report corporate wrongdoing to the government. SEC Rule 21F-4(b) presumptively excludes the use of privileged or confidential information from its definition of eligible original information under the Dodd-Frank whistleblower rule.<sup>4</sup> But there are exceptions to the SEC's general proscription of lawyers acting as whistleblowers. Where permitted by state ethics rules or by the SEC's own professional responsibility rules, SEC regulations authorize a lawyer to collect a whistleblower bounty. Ultimately, the courts will decide how to reconcile the government's encouragement of whistleblowers—including lawyers—with the traditional state regulation of lawyer ethics, including conflicts of interest and client confidentiality.

### Client Confidentiality and Client Fraud

Legal ethicists continually attempt to balance lawyers' competing duties of client confidentiality with their duties of honesty to tribunals and others. Lawyers confronted with material, ongoing client fraud must analyze their duty of confidentiality to the client

to determine whether disclosure is permissible under state and federal ethics rules. The ABA Model Rules, which serve as guidelines but lack the force of law, exhort lawyers to maintain the confidentiality of information learned by the lawyer in the course of the representation. However, ABA Model Rule 1.6 permits (but does not require) disclosure of confidential information in six circumstances: (1) to prevent death or substantial bodily harm; (2) to prevent crime or fraud “that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer’s services”; (3) to prevent or rectify financial injury from client crime/fraud “in furtherance of which the client has used the lawyer’s services”; (4) to obtain advice about the lawyer’s own compliance with the ethics rules; (5) for the lawyer to defend herself against a claim relating to the representation; and (6) to comply with law or a court order.<sup>5</sup> Exceptions (2) and (3) to Model Rule 1.6(b) were added in 2003 in the wake of the Enron and WorldCom financial scandals.

Different states have varying formulations of lawyer professional responsibility when confronted with known ongoing client fraud and illegality. For example, the New York Rules of Professional Conduct are different from their ABA counterparts, as they do not include the so-called Enron exceptions in Rule 1.6 (b) (2) and (3). The New York Rules prevent a lawyer from disclosing client confidential material, but provide exceptions. A New York lawyer may (but is not required to) reveal client

confidences: (1) to prevent reasonably certain death or substantial bodily harm; (2) to prevent a client from committing a crime; (3) to withdraw a lawyer’s opinion or representation based on inaccurate information or which is being used to further a crime or fraud; (4) to get legal advice about the lawyer’s own conduct; (5) for the lawyer to defend himself; (6) to collect a fee; (7) when permitted to reveal confidences under the RPC, to comply with law or a court order. While the foregoing exceptions are permissive, in the case of known client perjury, the lawyer is required to take reasonable remedial action, “including, if necessary, disclosure to the tribunal.”<sup>6</sup>

Lawyers who represent corporations and other organizations have additional ethical obligations in the event of known client violations of law. Under ABA Model Rule 1.13, a lawyer for an organization who has knowledge of corporate wrongdoing that poses a substantial risk of injury to the organization must report the violation up the proverbial corporate ladder. A corporate lawyer who knows that an officer or employee of the organization has engaged in illegal conduct related to the representation that is likely to result in substantial injury to the organization, “shall proceed as is reasonably necessary in the best interest of the organization.” Under the ABA rules, up-the-ladder reporting, including to the board of directors, is ethically mandated: “Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances,



to the highest authority that can act on behalf of the organization as determined by applicable law.”<sup>7</sup>

However, the ethics rules in various states, including New York, vary from the ABA formulation.<sup>8</sup> New York RPC 1.13 requires a corporate attorney aware of client misconduct that constitutes a violation of law or of a legal duty to the corporation to take reasonable measures within the organization to prevent harm to the organization, but does not contain independent support for reporting outside the organization if such reporting might result in disclosure of confidential information in violation of the state confidentiality rule.<sup>9</sup>

In addition, lawyers for public corporations have ethical obligations under Securities and Exchange Commission professional responsibility rules. For example, SEC Rule 205.3, like the ABA Model Rules, requires a lawyer who is aware of a material violation of the federal securities laws to report the violation up the corporate ladder to the highest authority which can act on behalf of the corporation, including, if necessary, the full board of directors. If all else fails, and if necessary to prevent further harm to the corporation or to investors by client perjury or a material violation of the securities laws, the Chief Legal Officer is authorized by SEC rules to disclose client confidences outside the company.<sup>10</sup>


State and federal ethics rules, however, are not in complete agreement about when it is permissible for lawyers to reveal—and benefit from—client violations of the securities laws.

## **NYCLA Ethics Opinion 746**

A potential conflict between federal and state ethics rules was addressed by the Professional Ethics Committee of the New York County Lawyers’ Association (NYCLA), whose 2013 ethics opinion considered the question, “May a New York lawyer ethically participate in the whistleblower bounty program under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 by revealing confidential information about the lawyer’s client and then seek a bounty?”<sup>11</sup> NYCLA Opinion 746 concluded that a New York lawyer, acting on behalf of a client, is presumptively barred from participating in a whistleblower bounty program by the New York Rules of Professional Conduct (RPC). Among other things, the committee reasoned that attorney participation in the SEC whistleblower program might permit or encourage the disclosure of confidential client information beyond that permitted by the New York Rules of Professional Conduct. In addition, the ethics committee found that the prospect of receiving a substantial monetary bounty from the government might give rise to a significant risk of a conflict between the lawyer’s interests and those of the client.

The NYCLA Ethics Committee further wrote that participation in a whistleblower bounty program would be unlikely to fall under the confidentiality exceptions of the Rules of Professional Conduct that permit disclosure of confidences “to the extent the lawyer reasonably believes necessary” to prevent the client from committing a crime or to prevent or rectify a known fraud on a tribunal.<sup>12</sup> It





reasoned that collecting a monetary bounty from the government is rarely necessary, and that “preventing wrongdoing is not the same as collecting a bounty.”<sup>13</sup>

Additionally, the NYCLA Committee reasoned that the prospect of a lawyer seeking a whistleblower bounty raises a potential conflict of interest. A lawyer seeking to benefit personally from the disclosure of confidential information could run afoul of RPC 1.7, which precludes representation of a client, absent waiver, where a reasonable lawyer would conclude that “there is a significant risk that the lawyer’s professional judgment on behalf of a client will be adversely affected by the lawyer’s own financial, business, property or other personal interests.”<sup>14</sup> The Committee reasoned that the prospect of a financial bounty might adversely affect the lawyer’s professional judgment on behalf of the client. In other words, if a lawyer is required to disclose confidential client information, it should be because the law requires it—not because the lawyer stands to benefit financially.

### **Fair Laboratory v. Quest Diagnostics**

In 2013, the U.S. Court of Appeals for the Second Circuit decided *Fair Laboratory Practices Associates v. Quest Diagnostics*, a *qui tam* case brought by an in-house lawyer-whistleblower who alleged that his former employer had violated the federal False Claims Act.<sup>15</sup> In that case, Mark Bibi, the defendant’s former general counsel, brought a federal *qui tam* action against his erstwhile employer. The defendant company claimed that Bibi had breached state ethics rules by using confidential information to bring his claim. Bibi opposed the defendant’s motion to dismiss, arguing that the False Claims Act preempted state ethics rules. Alternatively, he argued that the disclosure fell within an exception to the predecessor to New York RPC 1.6(b) in order to prevent the client from committing a crime.

The district court dismissed the plaintiff’s action because he unnecessarily and improperly revealed confidential client information. The Second Circuit affirmed the dismissal, reasoning that the False

Claims Act did not preempt the confidentiality provisions of the Rules of Professional Conduct, which would permit the disclosure of confidences only to the extent “reasonably necessary” to prevent a crime—including a federal crime. There was no conflict between state and federal interests, because it was not necessary for the general counsel to reveal stale confidential information from years earlier in order to prevent fraud that was apparently no longer ongoing. Moreover, the court reasoned that, whatever one’s view of the evidence, it was not reasonably necessary to bring a *qui tam* action—and recover monetarily—in order to redress the alleged past improper conduct by the defendant laboratory. According to the Second Circuit: “We agree that the attorney in question, through his conduct in this *qui tam* action, violated N.Y. Rule 1.9(c) which, in relevant part, prohibits lawyers from ‘us[ing] confidential information of [a] former client protected by Rule 1.6 to the disadvantage of the former client,’ N.Y. Rule 1.9(c), except ‘to the extent that the lawyer reasonably believes necessary . . . to prevent the client from committing a crime.’”<sup>16</sup>

The Second Circuit, relying in part on NYCLA Ethics Opinion 746, held that Bibi’s revelation of confidential information exceeded what was reasonably necessary to prevent any alleged ongoing fraudulent scheme.<sup>17</sup> As the court explained, it simply was not necessary, within the meaning of the ethics rules, for the plaintiff lawyer to reveal confidential information in order to remedy or prevent supposed client wrongdoing that occurred several years earlier:

We agree with the District Court that the confidential information Bibi revealed was greater than reasonably necessary to prevent any alleged ongoing fraudulent scheme in 2005. By [the plaintiff’s] own admission, it was unnecessary for Bibi to participate in this *qui tam* action at all, much less to broadly disclose Unilab’s confidential information. . . . Instead, Bibi chose to participate in the action and disclose protected client confidences in violation of N.Y. Rule 1.9(c).<sup>18</sup>



The court thus concluded that the entire case was infected by the attorney's unethical disclosures, and was not improperly dismissed by the district court.

### **Danon v. Vanguard Group Inc.**

In November 2015, the Supreme Court of New York, County of New York followed *Fair Laboratory Practices* and NYCLA Ethics Opinion 746 to dismiss a state court complaint brought by a lawyer in *State of New York ex rel. Danon v. Vanguard Group, Inc.*<sup>19</sup> In that case, David Danon, a former in-house tax attorney for Vanguard Group, brought a *qui tam* action against his former employer. Danon alleged that Vanguard was engaged in illegal tax evasion in violation of the New York State False Claims Act. He repeatedly raised his concerns with his co-workers and supervisors, but was told to desist. His persistence purportedly resulted in Vanguard retaliating against him by firing him. Before leaving Vanguard, Danon amassed a trove of confidential documents to support his anticipated whistleblower claim, which he presented to the IRS, SEC, and New York Attorney General's Office. As of this writing, none of these agencies has brought an enforcement action against Vanguard.

As part of the ensuing action, Danon sought a bounty under the New York False Claims Act. In its response to Danon's complaint, Vanguard moved to dismiss, asserting that the suit was poisoned by Danon's breach of ethics. Specifically, Vanguard argued that Danon violated his duty of confidentiality by publicizing the tax documents to which he had access as

the company's tax attorney. Danon did not deny that the documents—which he accessed in his representation of Vanguard—were confidential. Rather, he contended that the ethics rules allow such a breach of confidentiality, because doing so was necessary to prevent a crime or fraud.

The court found for Vanguard on a motion to dismiss and dismissed Danon's claim, reasoning that Danon's breach of confidentiality was in violation of New York's Rules of Professional Conduct 1.6 and 1.9(c). The court reasoned that the crime-fraud exception to the duty of confidentiality did not apply because Danon had alternative means to prevent the alleged tax violation, such as reporting his claims to the tax authorities; therefore, revealing Vanguard's confidential material was not "reasonably necessary" to prevent Vanguard from committing a crime. According to the court, this ethical violation undermined the evidence supporting the tax fraud accusations against Vanguard and poisoned the entire action.

The *Danon* court relied extensively on *Fair Laboratory Practices*, determining that not only was the lawyer whistleblower disqualified from collecting a False Claims Act bounty, but also that the breach of confidentiality was so egregious that it warranted dismissing the case outright. In fact, the court in *Danon* found that Danon's ethical violations were worse than those addressed in *Fair Laboratory Practices* because Danon gathered confidential documents and commenced his action while still in Vanguard's employ.

Undeterred, Danon pursued similar claims against Vanguard under the Sarbanes-Oxley Act, Dodd-Frank and the Pennsylvania Whistleblower law, in a separate action in the Eastern District of Pennsylvania. These claims were dismissed on collateral estoppel grounds by the court.<sup>20</sup> Both *Danon* decisions are on appeal.

Interestingly, in 2015, Danon participated in an action in Texas in which he successfully collected a bounty for information he provided.<sup>21</sup> His role was that of “confidential informant,” and not an active participant in the investigation. Thus, it is not entirely clear if he utilized the same confidential materials that tainted his case in New York. The Texas comptroller awarded Danon the sum of \$117,000 for his assistance.

## Conclusion

Lawyers confronted with client fraud or other material violations of the law must tread cautiously by balancing their competing duties under state and federal ethics rules, particularly given the developing nature of the law in this area. Generally speaking, lawyers must engage in a choice of law analysis to determine which jurisdiction’s professional responsibility law applies, and to determine whether disclosure is permissive, mandatory or precluded under the applicable ethics rules. In addition, lawyers must weigh and balance their own potential liability to potentially defrauded third parties – or government regulators—against their ethical duty of maintaining client confidentiality.

Both NYCLA Ethics Opinion 746 and the Second Circuit’s decision in *Fair Laboratory* caution that the disclosure of client confidential information in exchange for a government bounty raises significant ethical issues for lawyers. The *Danon* decision reinforces these opinions and stands to admonish attorneys against pursuing whistleblower bounties, especially if doing so reveals confidential materials beyond what is reasonably necessary to prevent client crime or fraud.

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1. *Fair Laboratory Practices Associates v. Quest Diagnostics Inc.*, 734 F.3d 154 (2d Cir. 2013).
2. *Danon v. Vanguard Group, Inc.*, No. 100711/13, 2015 WL 7594570 (N.Y.Sup.).
3. *Danon v. The Vanguard Group, Inc.*, No. CV 15-6864, 2016 WL 2988987 (E.D. Pa. 2016).
4. Securities Exchange Commission, *Implementation of the Whistleblower Provisions of Section 21F*, Exchange Act Release No. 34-64545, at 50-52, 60-66, 249-50 (Aug. 12, 2011), available at <http://www.sec.gov/rules/final/2011/34-64545.pdf>
5. ABA Model Rule 1.6 (b).
6. NY RPC 3.3.
7. ABA RPC 1.13.
8. Cf. NY RPC 1.13.
9. NY RPC 1.13.
10. SEC Rule 205.3 (d); <https://www.law.cornell.edu/cfr/text/17/205.3>
- NYCLA Ethics Opinion 746, at 1, [https://www.nycla.org/siteFiles/Publications/Publications1647\\_0.pdf](https://www.nycla.org/siteFiles/Publications/Publications1647_0.pdf). (The author is a member of the NYCLA Ethics Committee which issued Ethics Opinion 746).
12. NY ST RPC Rule 1.6(b); 3.3(b).
13. NYCLA, *supra* note 5, at 9.
14. *Id.* at 11.
15. *Fair Laboratory Practices Associates v. Quest Diagnostics Inc.*, 734 F.3d 154 (2d Cir. 2013).
16. *Id.* at 157-58.
17. *Id.* at 19.
18. *Id.* at 165.
19. *Danon v. Vanguard Group, Inc.*, No. 100711/13, 2015 WL 7594570 (N.Y.Sup.).
20. *Danon v. The Vanguard Group, Inc.*, No. CV 15-6864, 2016 WL 2988987 (E.D. Pa. 2016).
21. Jesse Drucker, *Vanguard, Facing Whistle-Blower Cases, Agrees to Pay Texas Taxes*, Bloomberg (Nov. 20, 2015), <http://www.bloomberg.com/news/articles/2015-11-20/vanguard-facing-whistle-blower-cases-agrees-to-pay-texas-taxes>.

# News of the firm

## Mound Cotton Wollan & Greengrass Recognized in Chambers

Mound Cotton Wollan & Greengrass was recognized by Chambers and Partners as a top firm in New York for the category *Insurance: Dispute Resolution: Insurer*. In addition to the firm's being acknowledged, two partners were highlighted as Leading Individuals in this category: **Lawrence Greengrass** and **Philip Silverberg**.

Chambers had the following to say about the firm and the recognized attorneys:

### What the team is known for

Notable for its work on direct insurance and reinsurance matters. Displays a range of coverage experience relating to catastrophic loss including first party property, business interruption and product contamination. Handles litigation as well as arbitrations, with strong capabilities in handling mass and toxic tort claims. Expertise includes fraud and bad faith disputes.

### Strengths

One client states: *"I'm extremely happy with their service. They are focused and extremely expert in their area. They are state of the art and up to date, and know all the issues pending in the field."*

Another source highlights the *"level of sophistication and value the firm brings to the table."*

### Work highlights

Successfully defended Zurich before the Second Circuit against business interruption claims related to the shutdown of a Canadian nuclear facility.

Acted for multiple insurers, including Travelers and AXIS, in a \$100 million builder's risk coverage dispute arising from damage and delays caused by Hurricane Sandy.

## Notable Practitioners



Lawrence Greengrass

The *"inventive and knowledgeable"* **Lawrence Greengrass** is well regarded in the insurance and reinsurance market. He frequently acts on reinsurance arbitrations, as well as court litigation. His expertise includes property and casualty disputes and life and health claims.



Philip Silverberg

**Philip Silverberg** is noted for his expert representation of insurers and reinsurers in disputes such as environmental tort and catastrophic event claims. He comes recommended as a *"smart, good adviser"* who *"goes the extra mile for his clients."*

## MCWG Fort Lauderdale office Announces New Partner



Brian McKell

Mound Cotton Wollan & Greengrass LLP welcomes Brian McKell to the firm as a partner in its Fort Lauderdale office. Brian has nearly 20 years of experience representing clients in complex commercial and insurance-related matters. His core practice focuses on first-party and third-party insurance coverage disputes, as well as professional liability, general liability, bankruptcy, and commercial litigation. Prior to Brian's 20 years of law firm experience, he worked in the insurance industry, handling professional liability, general liability, and property claims. Brian is admitted to the Florida Bar and the Federal District Courts for the Southern, Middle, and Northern Districts of Florida, as well as the 3rd and 11th Circuit Courts of Appeal. Brian joins Mound Cotton from Wilson Elser Moskowitz Edelman & Dicker, LLP.



## MCWG Co-chaired 2017 New York Power Conference

MCWG co-chaired the New York Powercon conference on May 4 at World Trade Center 1. New York Powercon is a one-day conference which focuses on cutting edge issues the power industry faces. With an ever-changing world, NY PowerCon is an energizing educational opportunity for insurance professionals to gain the knowledge necessary to handle these dynamic and complex claims.



Jeffery S. Weinstein of MCWG

## MCWG Partner Frank Montbach Recognized in Who's Who Legal Transport 2017



Francis Montbach

MCWG is pleased to announce that Francis Montbach has been selected for The International Who's Who of Legal Transport Aviation Attorneys 2017. The selections process is based on Who's Who research as well as clients and peers.

## MCWG Partner and Senior Counsels Recognized Among Who's Who Legal Insurance & Reinsurance: Lawyers

MCWG is pleased to announce that Stuart Cotton, Lawrence S. Greengrass, and Lloyd A. Gura have been selected for The International Who's Who of Insurance & Reinsurance Lawyers 2017 as being one of the world's leading Insurance & Reinsurance lawyers. The selections process is based on Who's Who research as well as clients and peers.

## Calendar of Speaking Engagements

### Past Events

**Brokers & Reinsurance Markets Association's  
Lunch & Learn**  
January 25, 2017  
Greenwich, Connecticut

Partner Amy Kallal presented on the topic, "The Sharing Economy & Impact On The Industry."

**Midwest Actuarial Forum**  
March 10, 2017

Partner Lloyd Gura presented at the Midwest Actuarial Forum in Chicago, IL.

**XL Catlin  
CE/CLE Webinar**  
April 6, 2017

Partner Jeffrey Weinstein was a lecturer at XL/Catlin's CE/CLE webinar series on the topic of "Coverage Issues Involving 'War Risks' and Terrorism Wordings."

**Brokers & Reinsurance Markets Association's  
Committee Rendezvous**  
April 24-25, 2017  
Bonita Springs, FL

Partners Amy Kallal and Michael Goldstein presented on the topic "Insurtech: Smart Contracts and Peer-2-Peer." The topic discussed this rapidly expanding industry and examining two of its larger sub-parts, Peer-2-Peer and Smart Contracts

**New York Powercon Conference**  
May 4, 2017

1 World Trade Center  
New York, NY

Partner Jeffrey Weinstein, founder and cosponsor, presented at this annual event held in the financial district of Manhattan that brings together insurance professionals for one day of continuing education.

**Practising Law Institute  
New Jersey Basic CLE Marathon**  
May 8, 2017

Partner William Wilson chaired PLI's New Jersey Basic CLE Marathon.



## Offices:

### New York City Office

One New York Plaza  
New York, NY 10004  
P: (212) 804-4200  
F: (212) 344-8066

### Long Island, New York Office

855 Franklin Ave  
Garden City, NY 11530  
P: (516) 417-5700  
F: (516) 741-6831

### New Jersey Office

30A Vreeland Road  
Florham Park, NJ 07932  
P: (973) 494-0600  
F: (973) 242-4244

### Florida Office

101 NE Third Avenue  
Fort Lauderdale, FL 33301  
P: (954) 467-5800  
F: (954) 467-5880

### California Office

1900 Powell Street, 6th Floor  
Emeryville, CA 94608  
P: (510) 900-9371  
F: (510) 900-9381