CHANCES ARE . . . A FORTUITY CASE STUDY

Acme Chemical Inc. v. Zenith Insurance Co.

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Disclaimers

• These are hypothetical loss scenarios presented for purposes of continuing professional legal education, and may not be duplicated, shared or used for any purpose other than presentation at the 2017 Annual Conference of the American College of Coverage and Extracontractual Counsel

• The facts presented are composite scenarios based on reported cases and the authors’ experiences across multiple property damage insurance claims involving catastrophic industrial losses. They are of “like kind and quality,” but are not factually accurate replicas of specific individual claims
Acme’s Insurance Program and Loss

• Claimant Acme Chemical Inc. (“Acme”) purchased a program of “all risks” property insurance
• Acme’s coverage is governed by terms of policy issued by Respondent Zenith Insurance Company (“Zenith”)
• On January 1, 2010, during policy period, a pressure vessel at an Acme facility ruptured, dispersing flammable process material that ignited, causing an explosion and fire that damaged or destroyed Acme’s insured property, and caused an interruption of Acme’s business
• Zenith Policy provides that New York law shall govern the interpretation and application of the Policy, and that all disputes shall be resolved through binding arbitration in Bermuda

Cause and Origin of Acme’s Loss

• Acme’s loss was caused by rupture of a vessel that resulted from damage to vessel’s shell caused by internal corrosion, capable of detection only by recognized internal inspection procedures
• The vessel that ruptured was part of a set of three cylindrical vessels through which process material flowed in sequence
• The vessels were part of a process chain that was designed to, and did, operate under both heat and pressure
• The temperature was highest as the process material entered Vessel A, and then decreased through Vessels B and C
Cause and Origin of Acme’s Loss

• The shell of Vessel A, subject to the highest temperatures, was made with an alloy steel and fully clad internally with stainless steel. These materials are less susceptible to corrosion than carbon steel
• The shell of Vessel B was made largely from carbon steel, except for a few feet at the hotter end where it received effluent from Vessel A and was lined internally with stainless steel
• The shell of Vessel C was made from carbon steel
• At equal temperature and pressure, carbon steel is more susceptible than alloy/stainless steel to the type of internal corrosion that caused Vessel B to fail

Cause and Origin of Acme’s Loss

• The particular form of corrosion that caused Acme’s loss is a gradually occurring damage mechanism well-known in Acme’s industry
• The two critical parameters on which corrosion attack depends are:
  • Temperature of the shell; and
  • Pressure inside the vessel
• Plotting the combination of these two variables results in curves
• Industry standards are developed from experience and published
• These standards set forth operating conditions under which corrosion damage is expected (or not expected) to occur in different kinds of steel
Cause and Origin of Acme’s Loss

• These curves are adjusted over time to reflect new reports of corrosion damage
• For a given type of steel, combinations of pressure and temperature “below” the curve are considered to be safe
• Similarly, combinations of pressure and temperature “above” the curve are not considered to be safe
• These standards constitute recognized and generally accepted good engineering practices (RAGAGEP)

Acme’s Mechanical Integrity Program

• At the time of loss, Vessel B was 40 years old
• A prior owner designed, constructed and installed the vessels in 1970
• Acme bought the facility in 2000
• Acme relied on third-party corrosion experts to evaluate its equipment
• In 2001, 2006 and 2009, these experts reviewed the metallurgy, operating conditions and process of Vessel B for susceptibility to the corrosion that occurred
• As part of the 2001 review, Acme took a temperature reading at the inlet (hot) end of Vessel B, and the reading was within the range thought to be safe. Acme did not regularly monitor the temperature at the inlet to Vessel B
• Between 2006 and 2009, Acme instituted certain process and operational changes that likely increased the temperature and pressure in Vessel B
Scenario A:

- None of the three corrosion reviews found that Vessel B was susceptible to this form of corrosion
  - One review erroneously assumed that Vessel B was fully clad in stainless steel
  - This assumption was not corrected
  - Vessel B failed at or near the seam between the cladding and the carbon steel
- Each review recommended that Vessel A, but not B, be internally inspected
- Acme included Vessel A, but not B, in program for internal inspection for this form of corrosion damage
- Acme never internally inspected Vessel B for this form of corrosion damage
- Acme was not aware of damage to Vessel B until post-incident laboratory testing
- If Acme had included Vessel B in its inspection program, it is more likely than not that Acme would have discovered the damage

Scenario B:

- Following the 2009 review, Acme inspected Vessel B and discovered the corrosion damage
- Acme solicited bids, from three international firms with extensive experience and qualifications in Acme’s industry, to repair the damage
- Acme elected to perform the repair in 2009 with its own work force, at considerably less cost than the three bids, but without the same level of expertise
- Acme continued to operate the vessels after the repairs without directly measuring vessel shell temperatures or internal pressures
- Post-incident testing determined that
  - The repairs had failed either to address past damage to Vessel B or to prevent future damage; and
  - Vessel B operated at a combination of temperature and pressure above the curve
Scenario C:

• Following the 2006 review, Acme inspected Vessel B and discovered the corrosion damage
• Acme conducted certain repairs as a temporary patch, and returned Vessel B to service until final repairs could be made
• Zenith was aware of Acme’s 2006 decision to return Vessel B to service and wrote to Acme reserving the right to deny any subsequent claim resulting from the Vessel’s return to service on the basis that such loss would not result from a fortuitous event
• Zenith renewed coverage and increased premium in 2007, and renewed coverage each year thereafter
• Vessel B failed in 2010 before final repairs were carried out
• Acme operators complained to management that continued operation with temporary repairs was not safe

The Fortuity Defense

Policyholder’s Perspective
Fortuity – The Test is Substantial Certainty

- Under New York law, a loss is fortuitous unless the insured:
  - Intended the loss, or;
  - Acted, or failed to act, with knowledge that the loss was substantially certain to result.
- Courts sometimes express this standard as acting with knowledge that the loss “would flow directly and immediately from the insured’s intentional act.”
  - Second Circuit rejected insurer’s argument that loss was not “fortuitous” because it was not “beyond the control of either party” within the meaning of N.Y. Ins. Law § 1101(a)(2).

The Test is Certainty, Not Control

- Some courts applying New York law have relied on New York Insurance Law in determining whether losses are fortuitous.
- Section 1101(a) of that statute defines “fortuitous event” as “any occurrence or failure to occur which is, or is assumed by the parties to be, to a substantial extent beyond the control of either party.”
  - Section 1101 properly applies to licensure, not coverage.
- Test of fortuity is not properly centered around degree of “control” that an insured exercises over the risk, and reliance on Section 1101 to support such an argument is misplaced.
- Non-fortuity requires certainty, and neither insured’s control of risk, nor even courting of risk, is sufficient to show non-fortuity.
The Test Is Certainty, Not Control

• Professor Edwin Patterson was an author of NY Insurance Law


... But to say that the insurer is not liable if the happening of the insured event was within the control of the insured would be erroneous or at least likely to mislead. Unless control means only designedly causing the insured event, a meaning narrower than the ordinary sense of the word, it includes a great many situations in which the insurer is undoubtedly liable. Thus, a defective chimney is “within the control” of the insured, since it can be repaired; yet fires due to defective flues are covered by the ordinary fire policy. Even if control is narrowed to include only situations of which the insured has knowledge, it is still too broad, since an insured who carelessly put off repairing a known defect in his chimney would not thereby be barred from recovering on his fire-insurance policy.

• Patterson, ESSENTIALS OF INSURANCE LAW 257-58 (2d ed. 1957).

Loss Resulting From Calculated Risk May Still Be Fortuitous

• “It is not enough that an insured was warned that damages might ensue from its actions, or that, once warned, an insured decided to take a calculated risk and proceed as before ... Recovery will only be barred if the insured intended the damages ... or if it can be said that the damages were, in a broader sense, ‘intended’ by the insured because the insured knew that the damages would flow directly and immediately from its intentional act ... .”

  • City of Johnston, 877 F.2d at 1150 (emphasis added; citations omitted).

• Fortuity doctrine does not bar coverage for likely losses, i.e., known enhanced risks. “Even if the risk [of the loss that occurred] was known [by the insured], and known to be high,” when the coverage at issue was added to the policy, that would not bar coverage. Id.

  • National Union v. Stroh, 265 F.3d at 108 (citing City of Johnstown).
Loss Resulting From Calculated Risk May Still Be Fortuitous

• “A person may engage in behavior that involves a calculated risk without expecting that an accident will occur – in fact, people often seek insurance for just such circumstances . . . .”

• Rockslide example:
  • Rockslide, “while a known risk at the time the [all-risks] policies took effect, was not ‘substantially certain to occur,’” and was therefore fortuitous, even though:
    • it involved a sixty-ton boulder falling from a hillside above the insured’s store;
    • there had been rockslides before policies’ inception, including another sixty-ton boulder falling on the store; and
    • the insured was aware of the geologic instability of the hillside

Burden of Proof

• The insured under an all-risks policy has a “relatively light” burden of showing that its loss was fortuitous

• Once insured meets that burden, burden shifts to insurer to prove otherwise
  • In National Union, Second Circuit held that “[t]he initial burden of showing that the loss in question was fortuitous – here meaning that the inevitability of such loss was not known to the insured before coverage took effect – is on the insured party . . . Once that burden is met, the insurer must come forward with evidence showing that ‘an exception to coverage applies,’ including exceptions based on the non-fortuity or known loss doctrines.” National Union, 265 F.3d at 109 (citations omitted).
Applying the Certainty Standard To Hypothetical Scenarios

• Under any of the three scenarios:

  • Absurd to suggest that Acme would knowingly cause an explosion that destroys its property, interrupts its business, and threatens the lives of its employees, including the employees responsible for Acme’s mechanical integrity program

Applying the Certainty Standard To Hypothetical Scenarios

• The industry standards (curves) are developed from industry experience and adjusted over time to reflect new reports of corrosion
• At time of loss, Acme’s mechanical integrity program in full compliance with recognized and generally accepted good engineering practices (RAGAGEP) in regard to the vessels
  • After incident, industry standards altered to be more protective
• Acme’s mechanical integrity program also in compliance with Acme’s own internal inspection practices, which exceeded the requirements of RAGAGEP
• Acme engaged third-party corrosion experts to evaluate the equipment
  • Acme personnel lacked expertise to evaluate all equipment for every potential damage mechanism
  • Acme retained and relied on third parties with superior expertise
Applying the Certainty Standard To Hypothetical Scenarios

• Scenario A:
  • Acme did not know of the damage that caused the loss
  • That is enough to show that Acme did not know that an explosion would occur
  • Even accepting, in hindsight, that Acme could have discovered the damage does not mean that Acme knew that it was substantially certain that an explosion would occur

• Scenario B:
  • Acme knew of the damage, but thought it was repaired
  • Simply choosing least expensive, and in hindsight, inadequate repair alternative does not mean that Acme knew that it was substantially certain that an explosion would occur

Applying the Certainty Standard To Hypothetical Scenarios

• Scenario C:
  • Warning letters mentioned “risk” of catastrophic failure or explosion, but did not opine on how likely or how soon
  • So long as failure was a mere risk, even if a heightened risk, it remained insurable
  • Insurer explicitly took into account the possibility of catastrophic failure, and increased premium to account for it, and renewed year after year
    • Letter “reserving the right” to deny claims is not a part of the policy
    • The policy governs the claim, and insurer cannot unilaterally modify policy
The Fortuity Defense

Insurer’s Perspective

Fortuity is a required element of policies based on an “accident” or “occurrence”.


Under an all-risk policy, the insured’s prima facie case must establish (i) policy existence; (ii) insurable interest; and (iii) fortuitous loss, i.e., an event happening by chance or accident.

In an insurance contract, the parties are making a wager as to the likelihood that a specified loss will occur. If the loss has already occurred, or the insured knows it is certain to occur for undisclosed reasons, then the contract is not a fair bet.


**Why Have the Requirement**

New York Ins. Law § 1101: Fortuitous event is an occurrence which is to a substantial extent beyond the **control** of the parties.

**Key Component: Insured’s Control**

*Newtown Creek Towing Co. v. Aetna Ins. Co., 57 N.E. 302 (N.Y. 1900):* While the insured hoped the vessel would not strike the ice that was all around, he admittedly could not see the ice at night, but proceeded anyway heedless of the risk.

**Key Component: Insured's Causative Conduct**
The Burden of Proof

Catastrophic Loss – Burden of Proof Reality

Legally – the insured must prove the loss was caused by a fortuitous event, meaning an event happening by chance or accident

Practically – the insurer must present substantial evidence of the insured’s control and causative misconduct

The insurer must disprove the event was an accident or occurrence by showing the loss was known, planned, intended, or substantially certain to occur
Meeting the Burden – Critical Fact Development

Retained Experts Must Analyze

- The maintenance, inspection, and operational history of the equipment
- The cause(s) of the equipment failure
- The insured's non-compliance with controlling internal and industry standards
- The insured's heightened knowledge of the risks or dangers involved
- The insured's deliberate misconduct leading to the loss
The Immediate Goal – Avoiding Summary Judgment

The denial of summary judgment interjects substantial financial risk for the insured.

The insurer must make the case that a jury could reasonably find that the insured’s intentional acts prevent the loss from being attributable to mere chance.


Now, Turning to Acme . . .
A Significant Hurdle

Flying Blind = Intentional Misconduct
Points to Consider

- Is the collision with the wall an accident?
- Is the collision substantially within the insured’s control?
- Is the decision to fly blindfolded intentional misconduct of the type necessary to prove non-fortuity?

Acme’s Decision to Fly Blind

Flying Blind

- Willful misconduct in continued operation of vessel
- 40-year old vessel with recent episodes of leaks and fires
- No monitoring of critical temperature & pressure
- Severity of existing cracking and corrosion unknown
- No proper internal corrosion inspections
- Operations above the curve without determining damage caused
Deliberate Risk Taking with Known Danger

Insurance is not available for loss the insured knows of, planned, intended or is aware is substantially certain to occur.

When the rope burns in half, and the fall occurs, is that fortuitous?

Does continuing the rope walk in the face of known danger with the expectation that a fall will not occur constitute intentional misconduct sufficient to render the fall non-fortuitous?
Applying the Example to Acme’s Misconduct

Deliberately courted known risks to property and personnel – unacceptable

Continued vessel operation with history of fires and volatile leaks without repair – unacceptable

Implemented “accelerated” start-up procedures from 12 hours to 2 hours to mitigate the fires and leaks – unacceptable

Continued vessel operation above the curve in the known danger zone – unacceptable

Failed to know vessel’s operating temperatures and pressures; instead assuming these key parameters remained safe – unacceptable

In re Margulies, No. 18 Civ. 2645 (KPF), 2017 WL 10459548 (S.D.N.Y. Mar. 20, 2017)
No coverage for damage caused by insured driver who hit traffic director. “[T]he incident was not to a substantial extent beyond the control of either party.” Insurer was in control of his car, had the capacity to use his brakes, and chose not to do so. The situation was well within his capacity to avoid.

“[T]he requirement of a fortuitous loss is a necessary element of insurance policies based on either an ‘accident’ or ‘occurrence.’ . . . [I]f fault is created or an insurer’s own negligence is a proximate cause of the loss, a fortuitous loss does not exist. A claim for faulty workmanship, in and of itself, is not an occurrence; therefore, a failure of workmanship does not involve the fortuity required to constitute an accident.”

All risk policy covering “direct and accidental physical loss” to aircraft did not cover any co-insureds’ claims because “airframe and engine losses . . . were caused by the intentional misconduct of plaintiffs’ continued” who removed airplane parts after company’s bankruptcy and thus “the damage was not fortuitous.”

“[T]here is a factual issue as to whether Deep Sea properly repaired the vessel . . . if the jury credited Royal’s evidence, it could reasonably find that Deep Sea intentionally chose inadequate methods to repair the Aloha, despite being aware that those methods violated the standards required of Panamanian-flagged ships. The jury could then find Deep Sea’s actions to be intentional misconduct even in the absence of outright fraud. Deep Sea is therefore not entitled to summary judgment with respect to the fortuitous nature of the loss of the scientific equipment.”