CHOICE OF LAW
IN INSURANCE COVERAGE DISPUTES

Also in This Issue:
Actual Cash and Replacement Cost Values
Anti-Indemnity Statutes
Endorsements and the “Occurrence” Debate
Air Traffic Control Privatization
Removal of Commercial Airline Passengers

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Choice of Law: A Continuing Struggle in Insurance Coverage Disputes
By Lyndon Bittle and Derrick Ward
A court's decision concerning the (possibly outcome-determinative) law governing a coverage dispute can turn on how the forum court resolves conflict of law questions. Lawyers representing both parties can benefit from understanding the various approaches to these issues.

Math or Myth: Calculating Actual Cash and Replacement Cost Values
By Shannon O’Malley, Jonathon Held, Kenneth D. Ritter, Kristine Elkind, and Arnold F. Mascali
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TIP: A policy covering risks in multiple jurisdictions is likely governed by the law of the insured company’s headquarters.

TIP: Be sure to learn how the applicable jurisdiction measures actual cash value, which varies by state.
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By Gregory D. Podolak and Tiffany Casanova
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TIP: New endorsements that seek to define subcontracted “faulty work” as an “occurrence” for purposes of CGL coverage still need to be tested in court.

Air Traffic Control Privatization: A Litigation Viewpoint
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TIP: The United States is not liable for the negligence of its independent contractors or their employees.

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TIP: Under the FAA, a pilot’s decision to remove a domestic airline passenger cannot give rise to a damages claim unless the decision was arbitrary or capricious.
I can see it coming, usually. The little light that goes off when the gentleman I just met realizes I’m a lawyer and starts searching his brain for lawyer jokes. Often, I can even steal his thunder by blurting out the punch line before he does. I’m not offended. Some of these jokes are actually a little funny, like the one about St. Peter and the time sheets—look it up.

After a few chuckles about lawyers, sharks, and snakes, I am advised that I seem OK, but lawyers as a whole leave a lot to be desired. Relieved that I made the cut, I like to turn the conversation and ask about his personal experience with lawyers. I have learned that people often like and respect their own lawyer and generally have had good personal experiences with the legal profession. Their derision comes from the common lay perception that lawyers “get people off on technicalities” or “take advantage of the loopholes.” However, when they recount their own experiences with the justice system, most people express gratitude and respect for the lawyer who helped them. Ours is an honorable profession with an intractable PR problem: sometimes people don’t like our clients, their beliefs, or who they are; and when we do a good job, they sometimes don’t like us.

As I write this column, lawyers across the country are mobilizing to volunteer in the effort to find and protect thousands of migrant children, including toddlers and breastfeeding babies who are so young they cannot speak their names, let alone speak to advocate for themselves. The task ahead is staggering, the record keeping deplorable; and it is possible that some of these children may never be reunited with their families again. I am extremely moved by the response of the legal profession to this crisis. But I am not surprised.

Throughout our history, America’s lawyers have answered the call to help defend the powerless, unpopular, and vulnerable. Before we gained our independence as a country, John Adams put his career and reputation on the line to defend Captain Thomas Preston and the British soldiers accused of murder following the Boston Massacre. Recognizing that the rule of law was of paramount importance to our nascent country, he later wrote thus:

The Part I took in Defence of Cptn. Preston and the Soldiers, procured me Anxiety, and Obloquy enough. It was, however, one of the most gallant, generous, manly and disinterested Actions of my whole Life, and one of the best Pieces of Service I ever rendered my Country. Judgment of Death against those Soldiers would have been as foul a Stain upon this Country as the Executions of the Quakers or Witches, anciently. As the Evidence was, the Verdict of the Jury was exactly right. ¹

Lawyers have been at the epicenter of every great struggle for the soul of our nation. Lawyers drafted the Declaration of Independence, the Constitution of the United States, and the Emancipation Proclamation. Our founders believed that lawyers were so important to the protection of individuals in a democratic society that the right to assistance of counsel in all criminal prosecutions can be found in the Sixth Amendment to the Constitution.

We don’t have to go so far back in history to find lawyers who are heroes. The recent documentary film RGB portrays the life of Supreme Court Justice Ruth Bader Ginsberg. The film not only details her current accomplishments and popularity but also documents her decades-long struggle for equal rights. She founded the ACLU’s Women’s Rights Project in 1972 and successfully argued many landmark cases before the Supreme Court. Notably, she significantly furthered women’s rights when she

An Honorable Profession

Holly M. Polglase

¹ Adams, John, 1765–1808. American lawyer, statesman, diplomat, and statesman. He was a leader of the American Revolution and a strong supporter of the Constitution of the United States. He is best known for his work in defense of Captain John Preston and the British soldiers accused of murder following the Boston Massacre. His actions were crucial in establishing the rule of law in the United States.
won a case representing a man who was denied Social Security survivor benefits that, until that time, were available only to widows and not widowers. Howard Moore Jr. worked as a civil rights lawyer in Georgia in the 1960s. He didn’t make much money, was shot at, and run off the road; but he has no regrets. In 1971, Morris Dees founded the Southern Poverty Law Center, which to this day fights against racial and social injustice. From Mary Bonauto, who led the fight for marriage equality, to the young lawyers who recently have stood at airports with signs offering to help immigrants in need, the members of this honorable profession have time and again stood in front of their unpopular and defenseless clients to protect them from injustice.

Ours is a stressful profession. We take on the problems of others, spend our day making decisions and recommendations that have real world consequences for real people, and often become the targets of blame when things don’t go well. Lawyers take on the burdens of their clients when their clients are often at the lowest point in their lives. However, it is a rewarding profession. We deal with matters of great consequence and engage in complex problem-solving. We help people reach resolutions to conflicts that, if not resolved, could ruin their lives.

As I write this column, my last as chair of TIPS, I am extremely proud of the men and women of our Section and of the profession as a whole. It has been the honor of my life to have been selected to lead this organization of nearly 17,000 lawyers and thus contribute to the bar. Our justice system is not perfect, but it is regarded around the world as one of the fairest and most successful in history. As lawyers, we should, each and every one of us, be proud of the part that we play in America’s revered system of justice. It is indeed an honorable profession.

Notes

Managing and Litigating the Complex Surety Case

TRACEY L. HALEY AND CHRISTOPHER R. WARD, EDITORS

There is no more complex area of legal practice than the litigation of the “mega” construction surety case. Now updated and expanded, this comprehensive resource expertly analyzes the myriad issues that arise in complex surety cases. Including fully updated additional chapters that reflect developments in the law, this book examines the complex decisions facing the surety when confronted with litigation involving multiple parties, project locations, claimants, and potential sources of salvage. It also discusses privilege, developing a strategic road map for litigation, forums for dispute resolution, and how to effectively handle the complex cases from the surety’s perspective. Other topics include:

• Investigating and managing claims
• Salvage opportunities
• Strategies when faced with a bankruptcy proceeding
• Electronic discovery
• Proving and defending quality-of-work issues, time impact claims, and damages
• Preparing, presenting, and appealing the complex surety case

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• Preparing, presenting, and appealing the complex surety case
In 2016, the Tort Trial & Insurance Practice Section (TIPS) formed a Women Trial Lawyers (WTL) Task Force for the women of TIPS to collectively share experiences and information relating to the particular needs of women lawyers who try cases and hire trial lawyers. At the ABA Midyear Meeting in February, the TIPS Council voted to make the WTL a permanent committee.

Over the past two years, the task force demonstrated what the amazing women of TIPS can do. We have held interactive, roundtable discussions on topics of interest to our members at every TIPS in-person meeting. We sponsored highly successful networking receptions for all TIPS members at the fall meetings. We also put together outstanding CLE presentations at the TIPS meetings, focusing on programs for TIPS’s Section Conferences. Our panels have been some of the most well attended and well received at each conference. WTL-sponsored topics have ranged from women as first chairs at trial to implicit bias to men as allies and champions. We have hosted such notable panelists as Teresa Wynn Roseborough, general counsel of Home Depot; Sandra Phillips, general counsel, and Ellen Farrell, deputy general counsel, of Toyota Motor North America; Patti Rattner, managing attorney, Electric Insurance (the insurance arm of General Electric); April Savoy, general counsel of Acceptance Insurance; Karen V. Morton, senior vice president and deputy general counsel, corporate litigation, Liberty Mutual; Denise Keane, former general counsel of Altria; Sandra Yamate, CEO of the Institute for Inclusion in the Legal Profession; Floyd Holloway, counsel of State Farm Insurance Company; Alan Bryan, senior associate general counsel, legal operations, Walmart; Linda Bray Chanow, executive director, Center for Women in Law; D’Arcy Kennitz, executive director, National LGBT Bar Association; Cathy Schwamberger, associate general counsel, State Farm Insurance Company; Paulette Brown, immediate past president, American Bar Association; Rocky Dhir, CEO and president, Atlas Legal Research; and best-selling author Alton Harris, policy director, The Good Food Institute; Caroline Turner, principal, DifferenceWorks, LLC, and former general counsel of Coors Brewing Company; and Jennifer L. Rosato, dean and professor of law, DePaul University.

This year, we expanded our WTL track at the TIPS Section Conference in Los Angeles to include a Women’s Networking Luncheon, open to all conference attendees, featuring a prominent speaker addressing a topic of general interest.

Continued on page 19

Marcy Hogan Greer, chair of the Women Trial Lawyers Committee, is a partner with Alexander Dubose Jefferson & Townsend, LLP, in Austin, Texas, specializing in federal and state trial and appellate practice in courts throughout the country. Her practice consistently includes class action and mass tort cases, including federal and state multidistrict litigation. She is the national editor of the ABA/TIPS book A Practitioner’s Guide to Class Actions. Greer also is a member of the TIPS Council, the TIPS liaison to the ABA’s Commission on Women in the Profession, and a founder and member of the executive council of the Center for Women in Law. She can be reached at mgreer@adjtlaw.com.
Editorial Board Member: Catherine T. Surbeck

The Brief Editorial Board is pleased to welcome Cathy Surbeck as one of its newest members. Cathy, her husband David, and two daughters, Chloe (age 16) and Maya (age 13) reside in the suburbs of Philadelphia, Pennsylvania. Born in Ho Chi Minh City (Saigon), Vietnam, Cathy lived there until 1974, when she moved with her family to her father’s home island of Kauai, Hawaii. She grew up on Kauai in Wailua Homesteads, a town so small that when Cathy arrived on the University of Washington campus in Seattle to begin college in 1984, the university’s enrollment was larger than the population of Kauai.

Following graduation, Cathy attended Temple University School of Law. She experienced quite a culture shock, moving from Kauai to Seattle and then North Philadelphia. Her first job after law school was as a trial attorney in Travelers Insurance Company’s workers’ compensation department. Thereafter, she worked as a defense attorney for Rawle and Henderson representing employers, insurance carriers, and third-party administrators in workers’ compensation matters. In 1999, a plaintiffs workers’ compensation lawyer recruited her to join her firm, and since then, she has represented injured workers in workers’ compensation matters. “I guess it depends on whom you ask,” Cathy says with a smile, “as to whether I was on the ‘dark’ side early in my career or am professionally on the ‘dark’ side now.”

Cathy’s current firm, Freedman & Lorry, has a rich history in Philadelphia, representing injured workers’ and their families for 60 years. “Freedman & Lorry is a labor firm, so we provide counsel for workers’ and their families, their unions and employee benefit plans,” she says. “We represent longshoremen, seamen, hospital workers, construction workers, public employees, and workers in virtually every field. In addition, we have represented workers in work-related injuries in Pennsylvania, longshoremen under the LHWCA, and injured civilian workers and their families under the Defense Base Act.”

Cathy was recruited to ABA/TIPS by a fellow workers’ compensation attorney in Philadelphia, Stacey Tees. Upon attending her first TIPS meeting, the 2013 Fall Leadership Meeting in Minneapolis, she was appointed as a vice-chair of the Section’s Workers’ Compensation Committee. By 2016, Cathy had become the program chair for TIPS’s Midwinter Workers’ Compensation Meeting in New Orleans, the stand-alone CLE program for which TIPS shares alternating planning responsibility with the Workers’ Compensation Committee of the ABA Section of Labor and Employment Law.

Cathy became chair of TIPS’s Workers’ Compensation Committee for the 2016–2017 bar year and helped the committee plan the successful Midwinter Workers’ Compensation Meeting in Nashville held this past March. In addition to her involvement with the Workers’ Compensation Committee, Cathy has served on the TIPS CLE Board since 2016. She has been appointed by incoming TIPS Chair Roy Cohen to the 2019 Section Conference Task Force for New York and the Plaintiffs Practice Standing Committee.

Currently, Cathy is chair-elect designee for the newly formed TIPS Women Trial Lawyers Committee. “This is an exciting time for this committee,” Cathy says. “We originally were formed as a task force, cofounded and chaired by Maureen Mulligan, a fellow member of The Brief Editorial Board.” The Women Trial Lawyers Task Force achieved official committee status following TIPS’s 2018 Section Conference in Hollywood. “We are excited about the future,” Cathy says. “TIPS has a lot of fantastic women trial lawyers, and we’re looking forward to providing mentoring, programming, and content for younger women trial lawyers.”

Through Cathy’s involvement with the Section, the Workers’ Compensation Committee, and planning two stand-alone national workers’ compensation conferences, she has met many TIPSters. She works closely with Pennsylvania Workers’ Compensation Judge Todd Seelig on TIPS’s Workers’ Compensation Committee, as well as the Philadelphia Bar Association Workers’ Compensation Committee. Todd, who also is a member of The Brief editorial board and a former editor-in-chief of the magazine, included Cathy in several dinner gatherings with The Brief board during recent TIPS’s quarterly meetings. As a result, Cathy became friends with Mary Veed and Marlo Orlin Leach, current board members who also are both former editors-in-chief of The Brief. Mary, Marlo, and Todd Continued on page 19
TIPS NOTES

Update on the Latest Programs and Events in Your Tort Trial & Insurance Practice Section

2018 Fourth Annual Section Conference
Nearly 400 registrants gathered at the Loews Hotel Hollywood in Los Angeles, California, for TIPS’s fourth annual Section Conference in early May. The conference offered over 17 top-tier CLE sessions to choose from as well as 5 networking events, including the very memorable, sold-out 85th Anniversary Gala, held on a lovely evening under the stars at Paramount Studios. Other notable conference networking events included a complimentary Welcome Reception, a Young Lawyers Networking Reception, and a late-night gathering at Saint Felix Hollywood. In addition, TIPS hosted its first-ever Women’s Networking Luncheon held during a Section Conference, which featured a distinguished keynote speaker, the Honorable Virginia A. Philips, chief judge for the Central District of California, who charmed and captivated the audience with her stories and humor.

Also during the conference, the TIPS Law in Public Service Standing Committee partnered with Together We Rise on May 3 for a public service project to assist foster care kids in Los Angeles. When foster children move from home to home, they are usually given two trash bags to carry their belongings. To help foster kids have more positive experiences, more than 40 volunteers decorated and packed duffel bags for children in the foster care system.

TIPS offers its thanks to the Section Conference Task Force, led by Maureen Mulligan, Jennifer Kilpatrick, and Chris Ward, for all the hard work they invested to make this conference a success.

TIPS Council members gather with TIPS’s staff at the Section Conference in Hollywood for the final photo with retiring staff members Don Quarles, CLE coordinator (front row, second from left); Linda Wiley, membership specialist (front row, third from left); and Felisha Stewart, meetings coordinator (front row, sixth from right).

2019 Section Conference Slated for New York
Following the success of the recent Section Conference, TIPS is pleased to announce the fifth annual TIPS Section Conference, which will be held at the Westin New York at Times Square, May 1–4, 2019. With a great slate of industry professionals, judges, in-house counsel, and defense and plaintiffs counsel, next year’s Section Conference will be another must-attend event. Stay tuned for updates on the 2019 Section Conference.

TIPS Annual Business Meeting Reminder at the ABA Annual Meeting in Chicago
All Section members are encouraged to attend the TIPS Section Business Meeting and Leadership Breakfast scheduled from 8:00 a.m. to 9:00 a.m. on Sunday, August 5, at the Swissôtel, Chicago. In addition to the official election of TIPS officers and Council members for the 2018–2019 bar year, numerous TIPS general committees will be recognized with membership awards during the meeting and breakfast.
IPS Senior Meeting Planner Debra Dotson passed away unexpectedly on April 1, 2018, at her home in a Chicago suburb. Debbie was employed by the ABA for 28 years. In her key role with the Section she loved and served with dedication and grace, she had become a valued team member for staff and innumerable TIPS members nationwide who are deeply saddened by her loss.

Debbie is survived by her parents, Pastor and Mrs. Rufus Dotson, two brothers, one sister, and four nieces and nephews. Her life was celebrated by family, hundreds of friends, and dozens of ABA/TIPS members and staff on April 8 at a service at the Miracle Revival Center in Maywood, Illinois, where TIPS Chair Holly Polglase and Janet Hummons, TIPS director of meetings and CLE and Debbie’s close friend, were among those who delivered heartfelt eulogies.

“Debbie loved her job and made sure that everyone who attended a TIPS event had an excellent experience, one that would make them want to come back,” Holly reflects with fondness, emphasizing how Debbie’s management contributed to the success of the programs she worked on. “Through her competence and anticipation of what needed to be done, she also made the leaders she worked with look good,” she adds.

“Debra was an absolutely pleasure to work with,” TIPS Director Theresa Livingston says. “She always went about her work in a very professional manner, radiating warmth and positivity through her amazing smile.” Her sentiments are echoed by Jennifer Michel, TIPS associate director, who remembers being drawn to Debbie’s kindness as the first person she met in TIPS who patiently fielded Jen’s myriad questions as a new staff member. “She was always helpful, encouraging, and optimistic,” Jen says, recalling Debra’s unending patience for members and staff alike.

“I think Debbie enjoyed being a part of our team as much as we enjoyed having her as a part of us. She was a constant voice of compassion, sympathy, and gentleness.”

In addition to her ABA job, Debbie was the administrator of her father’s church and financial secretary of the denomination’s regional organization. “She was a respected and loved leader in her community and church as well as an integral part of making TIPS a success,” Holly says. “I cannot emphasize enough how smart, professional, and driven Debbie was. Yet she treated everyone with love and kindness. I will always miss being greeted by her warm smile and a big hug.”

The Brief editorial board joins all those expressing sympathy to Debbie’s TIPS colleagues and her family. Acknowledgements may be sent to the Dotson Family, 5912 W. Walton St., Chicago, IL 60631.
CHOICE OF LAW
A Continuing Struggle in Insurance Coverage Disputes

By Lyndon Bittle and Derrick Ward
Seasoned insurance litigators know much can hang in the balance when the court decides a choice of law question regarding which state’s law will apply to an insurance policy. Is the insurer entitled to offsets for settlement money obtained in a personal injury action? Can a plaintiff’s estate seek payment of underinsured motorist coverage in addition to funds awarded under the standard policy after a vehicular death? Does shoddy craftsmanship qualify as a covered “occurrence” under a commercial general liability (CGL) policy? The answers to these questions depend upon the state law applied to the policy, and understanding how the forum court arrives at an answer on that application can mean the difference between winning and losing for your client.

Courts faced with a conflict of laws that will significantly impact the outcome of a particular case have benefited from a few doctrinal formulations created to ease the task of deciding these difficult cases. As in many other areas of the law, perhaps none of these formulations has proved as influential as those put forward in the Restatements of Conflict of Laws.

This article provides a contemporary overview of current choice of law doctrines with an eye toward possible future developments. The article begins with the foundational doctrines employed in the current choice of law landscape. The focus then shifts to the insights of a prominent critic of the prevailing doctrines. Finally, the article addresses the current state of play for choice of law provisions included in insurance policies.

**First Restatement: Lex Loci Contractus**

The first restatement dealing with conflicts in choice of law, Restatement of Conflict of Laws (1934), captured the conventional wisdom of the time regarding choice of law for contracts, *lex loci contractus*. This rule commanded that

> the law of the place of execution governs questions regarding the formation of the contract, while the law of the place of performance governs issues relating to the performance of the contract.¹

The rule draws its philosophical underpinnings from the vested rights doctrine, which views a legal obligation established by contract as owing its existence to the laws of the territory in which it was established and eschews interference with such obligations by the laws of foreign territories.²

**Lex loci: consistency.** For most of the twentieth century, courts applied this “territorial” approach to interpreting and enforcing contracts, including insurance policies. *Lex loci contractus* and its companion in tort law, *lex loci delictus*, endured as long as they did because they provided consistency and easily applicable rules that produced minimal squabbling over which law to apply. As the Illinois Supreme Court noted, the traditional justifications for the *lex loci* doctrine were as follows: “1) It is relatively easy to apply; 2) It improves predictability of outcome; 3) It discourages forum shopping; and 4) It is symmetrical.”³ For these reasons, as well as stare decisis, many courts (not including Illinois) were satisfied with *lex loci* as a means of resolving questions of choice of law.

Indeed, *lex loci* was “still the law in the majority of jurisdictions” well into the 1990s, but by then courts and legal practitioners were witnessing a “significant modern erosion of the rule.”⁴ This erosion resulted from a changing environment for individuals and businesses in which movement and long-distance communication were the norm rather than the exception. *Lex loci* developed in a time in which interstate travel and business transactions were less common than today.⁵ During this earlier time, when business was conducted across state lines, there would be little trouble determining where the deal had been inked and the final handshake made.

**Less rigidity and compromised consistency.** But with the advent of electronic and telephonic communication and the increasing interconnectedness of business across state lines, the difficulty of determining where an agreement had been made and the failure of *lex loci* and the vested rights doctrine to account for the interests of other jurisdictions began to create problems. The rule was routinely criticized for being “unduly inflexible, leading to harsh and unjust results.”⁶ To avoid such results, courts began crafting exceptions and escape hatches; but, in doing so, they simultaneously undermined what had been regarded previously as one of the chief virtues of the rule—its consistency.

**Recent reliance on lex loci.** Before moving on to the alternatives to the traditional approach, we should note that *lex loci* is alive and well in some states. In *Goss v. Green*, the U.S. Court of Appeals for the Sixth Circuit applied Tennessee choice of law principles to determine which state’s law governed a coverage dispute for an injured trucker.⁷ Tennessee courts apply the law of the jurisdiction where the policy is “made and

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³ *32 Ill.2d 97, 210 N.E.2d 790* (1965).

⁴ *21 Ill.2d 119, 150 N.E.2d 817* (1958).

⁵ *21 Ill.2d 119, 150 N.E.2d 817* (1958).

⁶ *21 Ill.2d 119, 150 N.E.2d 817* (1958).

⁷ *701 F.2d 1039* (6th Cir. 1983).
A policy covering risks in multiple jurisdictions is likely governed by the law of the insured company’s headquarters.

delivered."14 Here, the insurance contract was made and delivered in Mississippi, so Mississippi law applied. That the accident had occurred in Tennessee with a Tennessee driver was immaterial. A similar approach was employed by the U.S. Court of Appeals for the Fourth Circuit, applying Maryland law, in 2016 in Interstate Fire & Casualty Co. v. Dimensions Assurance Ltd.9 The case involved a dispute about whether a nurse hired by a staffing agency and assigned to work in a particular hospital qualified as an employee of that hospital for purposes of the hospital’s insurance policy. The case had been filed in Maryland, so the court applied Maryland’s lex loci contractus choice of law principles to determine that because the insurance contract was delivered in Maryland, that state’s laws of interpretation would apply. A controversial ruling by the New York Court of Appeals in 2017 in Carlson v. AIG, Inc.,

Lyndon Bittle is a trial and appellate partner at Carrington Coleman in Dallas, Texas, and chairs the firm’s insurance group. He is a former chair and current active vice chair of the TIPS Insurance Coverage Litigation Committee, is a fellow in the American College of Coverage and Extracontractual Counsel, and is board certified in civil appellate law. His practice encompasses representation of policyholders in coverage litigation, as well as policy review and counseling as components of a broader business litigation and appellate practice. He may be reached at lbittle@ccsb.com. Derrick Ward is an associate at Carrington Coleman whose practice involves insurance coverage, employment litigation, representation of local governmental entities, and appeals. Before joining the firm, he gained significant experience in legal matters affecting public education in the United States. He may be reached at dward@ccsb.com.

though technically not a conflict of law case, broadly applied a statute affecting policies “issued or delivered” in New York, which could have significant ramifications in other contexts.10 The court held that a policy was “issued or delivered” in New York “where both insureds and risks are located in this state.”11

Second Restatement: Most Significant Relationship

Recognizing the deficiencies of and growing dissatisfaction with lex loci, the drafters of the Restatement (Second) of Conflict of Laws developed a different means of adjudicating choice of law questions concerning contracts. Rather than opting for the simplicity of lex loci, the second restatement created what most courts apply as a multifactor analysis to determine which state’s laws will apply. Specifically, sections 6 and 188 of the second restatement spell out the factors that a court should consider when making a choice of law.

Section 6. Section 6 provides the general choice of law principles that are to guide a court’s decision. Determining whether the forum state’s laws provides a definitive choice of law is an important first step in the analysis under section 6(1): “A court, subject to constitutional restrictions, will follow a statutory directive of its own state on choice of law.”12 Some states have general choice of law statutes that preclude or limit application of the restatement factors.13 Other states have choice of law provisions specific to insurance disputes. The Texas Insurance Code, for example, mandates application of Texas law to an insurance policy when

1. the insurance proceeds are payable to a Texas citizen or inhabitant; (2) the policy is issued by an insurer doing business in Texas; and (3) the policy is issued in the course of the insurer’s business in Texas;14

Arizona uses a negative formulation: its “statutes governing insurance contracts . . . do not apply to [p]olicies or contracts not issued for delivery . . . nor delivered in [Arizona].”15 Such provisions must be narrowly construed to avoid giving them “extraterritorial effect.”16 As noted above, the New York Court of Appeals held that a policy was “issued or delivered” in New York “where both insureds and risks are located in this state.”17

In the absence of a controlling statute, the second restatement directs courts to consider the following:

(a) the needs of the interstate and international systems, (b) the relevant policies of the forum, (c) the relevant policies of other interested states and the relative interests of those states in the determination of the particular issue, (d) the protection of justified expectations, (e) the basic policies underlying the particular field of law, (f) certainty, predictability, and uniformity of result, and (g) ease in the determination and application of the law to be applied.18

As the comments to section 6 note, in many cases these considerations are likely to be at odds with one another and require the court to make an accommodation of competing interests.

Section 188. With respect to contracts (including insurance policies), section 188 of the second restatement coupled with section 6 creates what many have come to know as the “most significant relationship” framework for determining which state’s laws apply.19

Section 188 instructs courts to apply the local law of the state that “has the most significant relationship to the transaction and the parties under the principles stated in § 6.”20 The contacts that a court should consider include the place
of contracting; the place of negotiation of the contract; the place of performance; the location of the subject matter of the contract; and the domicile, residence, nationality, place of incorporation, and place of business of the parties. Section 188 also includes a helpful presumption that when the contract is negotiated and to be performed in the same state, the law of that state will typically apply.

Section 193. The second restatement also includes a section specifically addressing insurance agreements. Section 193 says that courts should apply the law of the state that the parties understood to be the principal location of the insured risk. However, section 193 allows application of another state’s laws where “some other state has a more significant relationship under the principles stated in § 6 to the transaction and the parties,” in which case the law of the state with the greater relationship should apply.

The U.S. Court of Appeals for the Third Circuit applied the second restatement analysis required by New Jersey law in Mega Construction Corp. v. XL American Group. When Mega, a construction subcontractor, faced a lawsuit by the primary contractor for an apartment complex’s diminution in value allegedly caused by Mega’s shoddy workmanship, Mega sought assistance from its insurers. When they refused to defend Mega in the suit with the primary contractor, Mega filed suit in New Jersey.

Under New Jersey law, poor workmanship qualifies as an accident or occurrence for purposes of CGL coverage, and the insurers would have been required to defend Mega. But Pennsylvania law, applied by the district court, explicitly exempts faulty workmanship from the definition of occurrence, meaning that the insurers had no duty to defend.

The Third Circuit noted that New Jersey courts begin the choice of law analysis with section 193, which focuses on the “principal location of the insured risk.” A risk is principally located in a state if it occurred there during a “major portion of the insurance period.” The court emphasized that the construction work all occurred in Pennsylvania and that any accidents or occurrences resulting in property damage would have occurred in Pennsylvania. The court concluded that the parties reasonably understood Pennsylvania to be the state where the principal insured risk was located, so Pennsylvania law should apply—absent a more significant relationship established considering the principles of section 6.

To argue that application of New Jersey law would “foster harmonious relationships” between the states and fulfill “reasonably objective expectations,” Mega emphasized that it purchased the policies in New Jersey, paid premiums in New Jersey, and was incorporated and licensed to do business in New Jersey. The court disagreed:

We view Mega’s claims like this: Mega says the insurers must defend and indemnify it against a lawsuit filed in Pennsylvania, by two Pennsylvania companies (Washington and Merion), who allege Pennsylvania causes of action and seek damages for the loss in value from the sale of property located in Pennsylvania, that was allegedly caused by Mega’s faulty work done in Pennsylvania, under subcontracts entered into in Pennsylvania. In sum, Pennsylvania’s relationship to this dispute is the more significant one. The District Court rightly applied that state’s law.

As Mega Construction demonstrates, section 193 can be used to quickly adjudicate choice of law questions without delving into a lengthy analysis. However, the caveat for the section 6 principles leaves room for more extended and uncertain discussion in cases less plain than Mega Construction.

Other Multifactor Tests
These provisions of the second restatement have proved enormously influential, but they are by no means the only multifactor tests that courts have applied to decide choice of law questions.

Governmental interest test. California, for example, has modified the approach set out in the second restatement to create what is known as the “governmental interest” test. This test looks to the contacts set out in section 188 of the second restatement, but with a special emphasis placed on the interests of the states involved.

Center of gravity, or grouping of contacts, test. New York created its own analysis to replace lex loci contractus well before publication of the second restatement. Much like the second restatement, the “center of gravity,” or “grouping of contacts,” test seeks to apply the law of the state with the most significant relationship to the transaction and the parties.

For example, in Fireman’s Fund Insurance Co. v. Great American
Insurance Co. of New York, the parties disagreed about whether Texas or Mississippi law should be applied to an excess property insurance policy. The dispute arose after a dry dock in Texas collapsed, resulting in the loss of the dock and significant cleanup costs. The owner of the dry dock and the primary insurer then sued secondary insurers in New York to recoup losses associated with the dock and cleanup efforts.

Under New York’s center of gravity, or grouping of contacts, choice of law doctrine, courts apply the law of “the place having the most interest in the problem,” thereby giving that state “paramount control over the legal issues arising out of a particular factual context.” In determining which state has the dominant interest in the issues, New York courts consider “the places of negotiation and performance; the location of the subject matter; and the domicile or place of business of the contracting parties.”

If a policy insures risks in multiple states, New York courts consider the risk to be principally located wherever the insured’s domicile is located; the courts reason that because the parties to the policy knew that information at the time of contracting, application of the law of that state should conform with their expectations.

In Fireman’s Fund, the insured, Signal International LLC, argued that its domicile for purposes of choice of law analysis should be the domicile of its Texas subsidiary rather than its principal office in Mississippi. The court rejected that argument, noting that such a conclusion would lead to the result that multiple states’ laws could then become applicable to a single insurance policy. The court found that such a result would violate the norms of judicial economy and uniformity.

Having determined that Signal’s domicile was in Mississippi rather than Texas, the court agreed with the district court that, under New York choice of law principles, Mississippi law should apply because the policy covered risks in multiple states. Furthermore, the court went on to note a variety of written materials provided to Signal listing Mississippi as the choice of law for the policy in question, including the “Declarations” page of the policy itself.

The court also analyzed the other factors in the New York scheme, reciting the policy’s negotiation in New York and Virginia, the policy’s performance in Mississippi and Texas, the existence of roughly equal assets in Texas and Mississippi, Signal’s domicile in Mississippi, and the insurer’s domicile in Virginia. None of these factors weighed more heavily in favor of applying the law of a state other than Mississippi. Finally, the court said that the mere fact that the dry dock existed in Texas did not create an overriding interest in applying Texas law where the only matter in dispute was who would pay for the dock and cleanup, not whether someone would pay those costs.

Fireman’s Fund offers an example of multifactor analysis at its best. The court quickly arrived at a conclusion while adequately considering each factor that might weigh against its ultimate conclusion. However, one could easily imagine a situation in which the ultimate outcome of the choice of law question would be far less clear. For example, if the dispute concerned whether the cleanup for the dry dock pollution would be paid for at all, the court could find itself in a more difficult position, the likely outcome of which would be hand-wringing and an attempt to appear objective while making a subjective, perhaps arbitrary, judgment about which state’s law to apply.

Choice-influencing considerations. Another multifactor test is Professor Robert A. Leflar’s “choice-influencing considerations,” adopted by North Dakota. The U.S. Court of Appeals for the Eighth Circuit applied this approach in American Fire & Casualty Co. v. Hegel. The case involved a dispute between American Fire and the estate of a Papa John’s Pizza delivery driver who had been killed on the job in a car accident. The estate sought a $25,000 payout from the American Fire underinsured motorist policy carried by Papa John’s for all drivers. American Fire denied this claim; instead, the insurer sought a declaratory judgment in a North Dakota federal district court and promptly appealed when that court ruled in favor of the estate.

The only issue on appeal was whether North Dakota or Kentucky law governed the American Fire policy. Applying North Dakota choice of law principles, the court embarked on a two-pronged analysis.

First, the court considered all relevant contacts that might influence which law applied, analogous to the instructions provided by section 188 of the second restatement. Specifically, the court looked at Papa John’s place of incorporation, where the agent who sold the policy was located, where the policy was delivered, and where the policy had been negotiated (all Kentucky). The court also considered American Fire’s place of incorporation and where it received payment (both Ohio), as well as where it does business and the area that the policy was intended to cover (both nationwide). Finally, the court noted where the deceased employee worked, where the parties to the accident lived, and where the accident occurred (all North Dakota).

The second prong of the North Dakota analysis looks to Leflar’s choice-influencing considerations,
which aim to determine the choice that will promote (1) predictability of results, (2) preservation of interstate or international order, (3) simple application by the judiciary, (4) the forum's governmental interests, and (5) application of the better law.44 Although Dr. Leflar's scholarship predated the second restatement, these factors bear some resemblance to the general principles set out in its section 6. (In fact, Dr. Leflar was one of the advisers to the second restatement.)

Of particular importance to the American Fire court's conclusion with respect to the first prong was North Dakota precedent establishing that where a policy covers risks in multiple states, the location where the risk materializes is of diminished significance.

Turning to the second prong, the court concluded that special significance should be afforded the predictability of results where, as in the case of insurance contracting, the parties to a contract have given advance thought to the legal consequences of the contract. In support of this proposition, the court noted that while accidents are not planned, insurance contracts are, and all planned events regarding the insurance policy in the case took place in Kentucky. With respect to ease of judicial application, the court simply noted that federal courts are well suited for applying the laws of any state. And interstate order would not be offended by a choice of either state's laws, as judged by North Dakota's "manifest disrespect" standard, because application of either state's laws would not offend the other state.45

The governmental interests of the forum were found to be best advanced by applying Kentucky law. North Dakota precedent stated that "North Dakota can have no substantial governmental interest in regulating the relationship between out-of-state insurance companies and their out-of-state insureds."

Because both American Fire and Papa John's were out-of-state entities, North Dakota could not claim governmental interest in the choice of law.46

Finally, with respect to choosing the better law, the court found that while North Dakota required underinsured motorist coverage and Kentucky did not, neither law was inherently better—simply different. That factor of the analysis was neutral.

**Many difficulties arise from the multifactor approach to choice of law.**

Having diminished the importance of the North Dakota contacts as part of the first-prong analysis and finding two factors in favor of Kentucky law and none in favor of North Dakota law under the second prong, the court applied Kentucky law.47

**Issues with multifactor approaches.** This lengthy analysis reveals many of the difficulties that arise from the multifactor approach to choice of law.

The American Fire court's examination of Leflar's instruction to apply the better law is illustrative. The court could have waded into the realm of public policy and considered the relative merits of requiring underinsured motorist coverage, ultimately choosing to come down on one side of the issue or the other. Although the court regarded both positions as value neutral, the flexibility to choose whatever path the court deems fit at any given moment to decide choice of law questions raises concerns about the consistency with which multifactor approaches may be applied and increases the opportunity for a court to tailor the law to a desired outcome.

Similarly, the court easily could have come down differently on the question of governmental interest had it considered the driver, as an employee of Papa John's, rather than Papa John's, as the corporate entity, to be the insured. Viewed from that perspective, the court's entire rationale for discarding the governmental interest factor evaporates. The court would then find itself compelled to grapple with the legitimate and more difficult question of whether North Dakota had a sufficient interest in protecting its citizens' interests to merit application of North Dakota law when they engage with out-of-state insurers. Again, the potential for wildly divergent outcomes could leave some wanting for the abandoned formalism of the first restatement.

At base, all of these approaches seek greater flexibility to consider the interests of the parties and the states involved as well as the context in which the insurance agreement was made. The rationale behind these approaches was that they would avoid the rigid and, at times, undesirable consequences produced by the earlier lex loci contractus; but, as time has passed, these new and more flexible analyses have birthed criticisms of their own.

**A Prominent Criticism of Multifactor Tests**

In 2015, Judge Richard Posner took to task the current state of insurance choice of law doctrine in *Visteon Corp. v. National Union Fire Insurance Co.*48 The case involved a dispute between Visteon, an automotive parts manufacturer, and National Union, which provided worldwide liability coverage to Visteon. When a Visteon plant in Indiana was found to have leaked a toxic solvent into the soil and
groundwater, National Union refused to cover the expenses associated with the cleanup or the litigation resulting from the pollution. In the ensuing lawsuit and appeal, choice of law was a dispositive issue. Indiana law favored Visteon because Indiana does not enforce general pollution exclusion clauses and requires a policy to specify the toxic chemical leaked in order to exclude coverage for it, which National Union had not done. Michigan, on the other hand, does enforce general pollution exclusion clauses of the sort found in Visteon’s policy. Visteon was headquartered in Michigan, and the bulk of its facilities were in Michigan. Therefore, argued National Union, Michigan law would be most appropriate.  

The insurance policy covered Visteon in multiple states, and Indiana law requires courts to use the state’s “uniform-contract-interpretation approach” when evaluating choice of law questions governing such contracts. The approach requires the law of a single state to apply to the entire insurance contract even when the policy covers multiple risks in multiple states. Writing for the court, Posner observed that by applying the law of a single state to all disputes arising under the policy, Indiana’s choice of law principles provide insurers the ability to make premium calculations based on the law of one state, typically the state with the most insured sites. By contrast, Visteon’s favored approach, applying the law of the jurisdiction in which liability was incurred, would saddle insurers with the task of calculating premiums based on the law of each state or jurisdiction in which the insured might incur liability. The result would be a vast array of premiums tailored to the laws of myriad jurisdictions. The court cited National Union’s interests in having a uniform premium for all potential risks and in having a single jurisdiction’s laws govern the terms of its insurance contracts as compelling reasons that favored National Union’s position. Posner noted that Visteon had 14 facilities in Michigan, more than in any other state; headquartered its operations in Michigan; and stationed personnel responsible for negotiating and administering its contracts in Michigan. With these considerations in mind, the court concluded that application of Michigan law was appropriate.

Nevertheless, because of controlling Indiana choice of law precedent, the court “felt compelled to trudge through other factors, mainly the state where the risk insured against had materialized and the state where the insurance contract had been made.” The court dismissed consideration of where the risk materialized as unforeseeable and considered Indiana’s interest in the matter negligible given that Visteon had already paid for cleanup and compensated affected Hoosiers. As for the site of contracting, the court said that no state could rightly be “designated as ‘the’ state in which the contract was made” given that the contract had been negotiated, paid for, and signed in multiple states. In any event, none of those states was Indiana, so that factor became moot.

To avoid these difficulties, the court suggested that the “[s]implest of all solutions” would be for the insurers “to negotiate with its insureds for the designation of the jurisdiction whose laws would govern any litigation arising out of its insurance contracts.” Unfortunately, the court suggested, insurers are reluctant to make such agreements in advance for fear the grass might be greener in another state depending on what legal issue arises. Further, many states decline to enforce such provisions out of concern that insureds may be forced to give up legal protections intended to ensure that they can obtain coverage. In addition, as discussed in the next section, advance agreement to a particular state’s law is by no means as determinative as the Visteon court presumes.

**Agreements to be bound by the laws of a particular jurisdiction frequently face great hurdles in court.**

**Contractual Choice of Law Clauses**

Judge Posner’s preferred solution to the difficulties posed by conflicts of law would be for parties to a contract to agree in advance to the law that will govern their insurance agreement. While intuitively ideal, this proposition can face significant challenges when applied. In addition to the reluctance of insurers to make such agreements and the potential risk to insureds inherent in allowing insurers to choose their preferred rules, agreements to be bound by the laws of a particular jurisdiction frequently face even greater hurdles in court.

**Seventh Circuit case.** A recent example from the U.S. Court of Appeals for the Seventh Circuit, notably a panel that included Judge Posner, demonstrates the need for additional considerations even where parties to a policy make such agreements. While the agreement at issue was
TORT TRIAL & INSURANCE PRACTICE SECTION

looked to which state might have such an est in the outcome. To determine a materially greater interest in the outcome of the litigation and applied Texas law without regard for the agreement that disputes be governed by Illinois law. Texas law prohibits assignments of the sort at issue in Hendricks because they tend to increase and distort litigation, so the court found the assignment of the right to recover against Novae invalid.61

Second Circuit case. Another interesting example comes from the U.S. Court of Appeals for the Second Circuit in a case where the court considered whether a New York statute prevented an insurer from reducing the payout associated with a personal injury claim.62 In Arnone v. Aetna Life Insurance Co., Aetna, the insurer, argued that the New York statute did not apply because of a contracted choice of law provision stating that the policy would be “construed in line with the law of the jurisdiction in which it is delivered.”63 The policy had been delivered in Connecticut. However, siding with the insured, the court seized on the word construed, determining that the New York statute was a direct prohibition on the reduction of Arnone’s personal injury award and involved no question of contract construction. Because the New York law did not require interpretation of the insurance policy, the court found that it applied regardless of the choice of law clause.64

Final thoughts on contractual provisions. To be sure, inclusion of a choice of law provision can simplify disputes, and courts are inclined to honor them.65 But while insurers and parties to insurance contracts may rest a bit easier by including a choice of law provision, it is by no means fail-safe.

Conclusion

As noted in the original discussion of the lex loci contractus doctrine, the rigidity of the doctrine is ultimately what led it to fall out of favor with courts and commentators. But that rigidity cuts both ways and, in many circumstances, will deliver quick, predictable results without opening up the courts to criticism of activism or capricious decision-making. The multifactor tests reflected in the second restatement and other formulations are less rigid but are subject to criticism as tedious, unwieldy, unpredictable, and subjective. One common conclusion that can be drawn from the various approaches is that when one policy covers risks in multiple jurisdictions, the law of the state in which the insured business is headquartered is likely to govern, regardless of where the risk actually manifests.

The American Law Institute (ALI) has begun drafting the Restatement (Third) of Conflict of Laws, which will seek to address some of the dissatisfaction with the second restatement and the problems that have emerged since its introduction. The goal of the drafters, according to the ALI, “is to take the accumulated wisdom of decades of experience with the modern approaches and present it in an administrable and user-friendly form.”66 In many areas of law, there is a tendency to swing the pendulum too far in the other direction when presented with an opportunity to remedy an identified

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not an insurance policy, the subject matter is uniquely insurance related.

In Hendricks v. Novae Corp. Underwriting, Ltd., Cunningham became entangled in litigation with American Patriot Insurance Company. Cunningham became Novae Corporate Underwriting and American Patriot Insurance Company.57 Cunningham became American Patriot Insurance and American Patriot Insurance obtained insurance coverage from Novae Corporate Underwriting, Ltd. Cunningham became and American Patriot Insurance Company.57 Cunningham became and American Patriot Insurance obtained insurance coverage from Novae Corporate Underwriting, Ltd.

Aham Lindsey Claims Management related. The subject matter is uniquely insurance not an insurance policy, the sub-

(f) the domicile, residence, nationality, place of incorporation and place of business of the parties.58

The first two and last of these factors were considered neutral by the court, leaving only the place of performance and the location of the subject matter of the contract. The place of performance had been both Illinois and Texas since the contract’s inception, so that factor, too, was ultimately neutral. However, the subject matter of the agreement was settlement of litigation pending in Texas. Accordingly, the court determined that Texas had a materially greater interest in the outcome of the litigation and applied Texas law without regard for the agreement that disputes be governed by Illinois law. Texas law prohibits assignments of the sort at issue in Hendricks because they tend to increase and distort litigation, so the court found the assignment of the right to recover against Novae invalid.61

In resolving the dispute, the court applied the choice of law rules of Illinois, the forum state, which typically hold that a contract’s choice of law clause will govern what law is applied. The contract stated that Illinois law would apply, appearing to resolve the issue. However, following section 187 of the second restatement, the general rule gives way to other considerations when the chosen law creates a result that is contrary to the public policy of the chosen state or to that of a state with a materially greater interest in the litigation.59 After the court determined that there were no issues affecting Illinois public policy, the court considered whether another state had a materially greater interest in the outcome. To determine which state might have such an interest, the court applied section 188 of the second restatement and looked to

(a) the place of contracting, (b) the place of negotiation of the contract, (c) the place of performance, (d) the location of the subject matter of the contract, and (e) the domicile, residence, nationality, place of incorporation and place of business of the parties.58

The American Law Institute (ALI) has begun drafting the Restatement (Third) of Conflict of Laws, which will seek to address some of the dissatisfaction with the second restatement and the problems that have emerged since its introduction. The goal of the drafters, according to the ALI, “is to take the accumulated wisdom of decades of experience with the modern approaches and present it in an administrable and user-friendly form.”66 In many areas of law, there is a tendency to swing the pendulum too far in the other direction when presented with an opportunity to remedy an identified
fault. That was arguably the approach taken by jurists and scholars as they abandoned lex loci contractus in favor of slippery multifactor tests that can be manipulated to any favored outcome. For now, practitioners will have to wait to see whether the framers of the next restatement draft their modifications to the second restatement as tweaks or overhauls. Only a few chapters are currently under review; the next scheduled meeting is November 9, 2018. Considering that the second restatement took 20 years to come to fruition and even longer to be widely adopted, we should not expect a third restatement to be completed soon.

Meanwhile, where a coverage dispute may be subject to different outcomes under the substantive laws of more than one jurisdiction, deciding which law will govern depends on the forum court’s choice of law principles. If you have a choice of the forum in which that question will be answered, you might first consider the choice of law principles that each potential forum state will apply.

Notes

7. 664 F. App’x 560, 561 (6th Cir. 2016).
8. Id.
11. Id. § III.
12. Restatement (Second) of Conflict of Laws § 6 (1971).
17. Carlson v. AIG, 2017 WL 5557948, § III.
18. Restatement (Second) of Conflict of Laws § 6(2) (1971).
19. Id. § 188.
20. Id.
21. Id. § 193.
22. 684 F. App’x 196 (3d Cir. 2017).
23. Id.
24. Id.
25. Id. at 199.
26. Id. (citing Restatement (Second) of Conflict of Laws § 193 cmt. b).
27. Id.
28. Id. at 200.
29. Id.
31. 822 F.3d 620, 625 (2d Cir. 2016).
32. Id. at 625–26.
33. Id. at 642 (quoting In re Liquidation of Midland Ins. Co., 947 N.E.2d 1174, 1179 (N.Y. 2011)).
34. Id. (quoting Schwartz v. Liberty Mut. Ins. Co., 539 F.3d 135, 151–52 (2d Cir. 2008)).
35. Id.
36. Id. at 643.
37. Id. at 644.
38. Id. at 645.
40. 847 F.3d 956, 958–59 (8th Cir. 2017).
41. Id. at 958.
42. Id. at 959.
43. Id.
44. Id. at 959–61.
45. Id. at 962 (citing Plante v. Columbia Paints, 494 N.W.2d 140, 143 (N.D. 1992); Apollo Sprinkler Co. v. Fire Sprinkler Suppliers & Design, Inc., 382 N.W.2d 386, 391 (N.D. 1986)).
46. Id.
47. Id. at 961–63.
48. 777 F.3d 415 (7th Cir. 2015).
49. Id. at 416–17.
50. Id. at 418.
51. Id.
52. Id. at 418–19.
53. Id. at 419.
54. Id.
55. Id.
56. Id.
57. 868 F.3d 542, 544 (7th Cir. 2017).
58. Id. at 544–45.
59. Id. at 545.
60. Id. (quoting Restatement (Second) of Conflict of Laws § 188 (1971)).
61. Id. at 545–46.
63. Id. at 107 (quoting Joint App’x at 91).
64. Id. at 107–09; see also Selective Ins. Co. of S.C. v. Target Corp., 845 F.3d 263, 266 (7th Cir. 2016), as amended (Jan. 25, 2017) (court disregarded choice of Minnesota law because the parties had argued the case under Illinois law).
65. See, e.g., Restatement (Second) of Conflict of Laws § 187; Ratajczak v. Beazley Solutions Ltd., 870 F.3d 650, 656–57 (7th Cir. 2017) (declining to allow makers of protein concentrate to escape the choice of law provision in their insurance policy); H.J. Heinz Co. v. Starr Surplus Lines Ins. Co., 675 F. App’x 122, 127 (3d Cir. 2017) (enforcing choice of law provision in an action to rescind a policy and rejecting claim that invocation of the clause ratifies the policy).
Women Trial Lawyers Committee

Continued from page 6

Our keynote speaker, the Hon. Virginia Phillips, chief judge of the U.S. District Court for the Central District of California, gave an incredibly inspirational speech to a sold-out crowd.

WTL aims to match women trial lawyers with opportunities for skills building, court appointments, and networking events. The TIPS/ABOTA National Trial Academy also will benefit from the WTL because a key focus of the national initiative to develop more women in lead trial roles is to provide specialized training, and the Trial Academy is one of the best in the country.

We are delighted with the excitement and support from TIPS for the WTL Committee. In addition to bringing our TIPS women together to support a common cause, there are many TIPS women trial lawyers who are involved in women lawyer groups both nationally and locally, which enhances the collective experience and information sharing of the TIPS WTL Committee. Two of our members currently serve as appointed commissioners of the ABA’s prestigious Commission on Women in the Profession—our immediate WTL past chair Maureen Mulligan and former TIPS Chair Sandy McCandless.

With three consecutive female ABA presidents and other indicators of the growth of women in the profession—and intense focus on the need for more—the timing is right to cement the WTL initiative into a permanent TIPS committee.

The WTL Committee holds in-person meetings at each TIPS quarterly meeting, as well as periodic calls throughout the year. Our in-person meetings usually involve interactive sessions, as well as educational opportunities on a wide variety of subjects affecting women trial lawyers.

The 2018–2019 bar year should be another fabulous year for the WTL as we begin our first year as a permanent committee under the leadership of Chair-Elect Jennifer Kilpatrick. We welcome the participation of all TIPS women who are interested in taking their work very seriously,” Cathy says. “This publication adds so much value for TIPS members, and I was excited about the prospect of being part of its creation.” When answering her “life after chair” questionnaire for TIPS, she indicated an interest in The Brief, and, as she says, “the rest is history.”

In addition to her TIPS leadership roles, Cathy is active in the Philadelphia Bar Association Workers’ Compensation Committee, as well as the Workers’ Injury Law Group, for which she serves on the membership committee. She can be reached at csurbeck@freedmanlorry.com.

Catherine T. Surbeck

Continued from page 7

encouraged her participation, and she became appointed to The Brief Editorial Board in 2017.

“The Brief board members are such a great group of folks who take their work very seriously,” Cathy says. “This publication adds so much value for TIPS members, and I was excited about the prospect of being part of its creation.” When answering her “life after chair” questionnaire for TIPS,
MATH OR MYTH: CALCULATING ACTUAL CASH AND REPLACEMENT COST VALUES

By Shannon O’Malley, Jonathon Held, Kenneth D. Ritter, Kristine Elkind, and Arnold F. Mascali
At first glance, the terms actual cash value and replacement cost seem innocuous and relatively easy to calculate. However, in the context of property insurance claims, there is nothing simple when it comes to measuring property damage under either actual cash value (ACV) or replacement cost. In fact, there is a plethora of issues that arise in the context of measuring ACV and replacement cost.

Although claims have been measured on the basis of ACV and replacement cost for years, courts still are grappling with what values should be included or discarded when calculating claims. Importantly, the answer as to what should be considered when measuring a claim on the basis of ACV or replacement cost varies from state to state. Courts consider issues such as depreciation, including whether labor, overhead, and profit may be depreciated; what constitutes “like kind and quality” with respect to replacement cost; valuation of stock, including issues such as obsolescence; the effect of outside forces such as area-wide catastrophes; and how these measurements affect other policy provisions.

**ACV and Limits on Calculating Depreciation**

When an insured sustains property damage, the insurance policy’s valuation provision typically defines how that damage will be measured. A policy’s default valuation is usually ACV. The insured often has the option to purchase replacement cost value coverage, but the calculation of the ACV is relevant and necessary because an insured’s coverage for replacement cost generally only applies once the insured actually repairs or replaces the damaged property.

Therefore, the question often confronted by insureds, their insurers, and insurance consultants is this: How is ACV properly measured? If you ask a “man on the street” how ACV is defined, an answer may be replacement cost less depreciation. In fact, Merriam-Webster’s Collegiate Dictionary defines ACV as “money equal to the cost of replacing lost, stolen, or damaged property after depreciation.”

Many states also define ACV in this manner. For example, the Supreme Court of Nebraska recognized that

> [standard casualty protection for residential and commercial property insures the property only to the extent of its actual cash value. Actual cash value is the value of the property in its depreciated condition. The purpose of actual cash value coverage is indemnification. It is to make the insured whole, but never to benefit the insured because the loss occurred.]

Still other states, though, define ACV as “fair market value.”

However, determining depreciation, or even fair market value, is not a straightforward task. This is, in part, because replacement cost includes the cost of labor and, often, a contractor’s overhead and profit. Arguably, if a state defines ACV as replacement cost less depreciation, all aspects of the replacement cost should be depreciated.

States recognize that depreciation and ACV cannot have a one-size-fits-all approach. In fact, the question of whether labor and overhead and profit should be depreciated when measuring ACV has been a hot topic among courts recently.

**Minnesota.** The Minnesota Supreme Court recently addressed a certified question concerning whether an insurer may depreciate the cost of labor in determining ACV. In *Wilcox v. State Farm Fire & Casualty Co.*, the insurer, to estimate the ACV,

first calculated the replacement costs of individual items, such as roof flashing, siding, fascia, gutters, and window screens. Next, [the insurer] subtracted the pre-loss depreciation of some, but not all, individual items. For example, [the insurer] depreciated the cost of removing and replacing certain materials, such as siding. [The insurer] did not depreciate the cost of the new siding separately from the cost of the labor required to install the new siding on the home. Rather, [the insurer] calculated the removal and replacement of the siding as a single cost, then depreciated the removal-and-replacement cost as a whole.

The insured filed a class action alleging that the practice of depreciating “embedded labor” is unlawful under Minnesota law. The court ultimately determined that calculation of ACV is a fact issue and that the trier of fact may consider labor-cost depreciation in determining the ACV of a covered loss when the estimated cost to repair or replace the damaged property includes both materials and embedded labor components. The court recognized that “a black letter rule that categorically excludes or requires embedded-labor-cost depreciation would be simpler to administer,” but it concluded under its legal precedent that Minnesota courts should apply “the flexible broad evidence rule in order to effectuate indemnity in the fairest manner even though it . . . involve[s] the sacrifice of administrative convenience and of simplicity.”

**Tennessee.** Similarly, a court in Tennessee certified a question to the Tennessee Supreme Court on this issue.

The policies at issue defined ACV as

> the cost to replace damaged property with new property of similar quality and features reduced by the

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amount of depreciation applicable to the damaged property immediately prior to the loss.9

The insurer measured the loss by estimating the cost to repair with new materials and then subtracted depreciation, including labor.10

The court recognized that measurement of ACV under Tennessee law involved more than simple depreciation. It further recognized that the question of whether labor costs can be depreciated has resulted in decidedly mixed results in other jurisdictions, depending upon the state law at issue and the policy language.11

The court therefore certified to the Tennessee Supreme Court the question as to whether labor may be depreciated in measuring ACV.

Missouri. The U.S. Court of Appeals for the Eighth Circuit analyzed whether the depreciation percentage could be applied to labor under Missouri law. The court recognized that the “basic premise of traditional property insurance is the concept of indemnity”12 and that a policy that pays on an ACV basis makes the insured whole but does not put the insured in a better position.13 Essentially, a payment on an ACV basis takes into account the property’s condition at the time of the loss.

Under Missouri law, ACV is defined as “the difference in the fair market value of the damaged property immediately before and after the loss.”14 Despite this seemingly straightforward definition, the Eighth Circuit recognized that the factors that should be considered in measuring this difference may vary and that conflicting estimates may be presented by the parties.

The court determined that it matters not whether “labor” is customarily depreciated in other business accounting contexts. The question is whether deprecating what a contractor will charge to replace the partial loss is a reasonable method of estimating “the difference in value of the property immediately before and immediately after the loss.”15

The court found that the embedded-labor-cost depreciation method to calculate ACV is a tool for estimating ACV. It ultimately found, though, that measurement of ACV is a question of fact that should be considered by the jury, including whether labor should be depreciated.

Thus, practitioners, consultants, insurers, and insureds must carefully review their jurisdiction’s law in determining the correct way to measure ACV.

California. Some states statutorily mandate how ACV is measured. For example, California limits the ACV depreciation deduction by excluding depreciation on the labor component inherent in the calculation of replacement cost.16

Regulations implementing California’s statutes require insurers to itemize, justify, and fully explain all adjustments to the amount claimed, including for depreciation—and that depreciation must be attributable to the condition and age of the property.17 This is set forth in the California Code of Regulations, which specifically precludes depreciation of labor: “the expense of labor necessary to repair, rebuild or replace covered property is not a component of physical depreciation and shall not be subject to depreciation or betterment.”18

Calculating Replacement Cost: Like Kind and Quality

Many insureds choose to pay the additional premium for replacement cost coverage. But how replacement cost is measured is not always black and white because it is rarely the case that an insured’s property can be replaced with an exact duplicate. Thus, policies typically qualify replacement property as being of “like kind and quality.”

Determining what constitutes like kind and quality is one of the continuing challenges facing insureds and insurers. Generally speaking, the term like kind and quality is not defined in the insurance policy, leaving the determination to the policyholder and the insurer’s representative. Moreover, within insurance policies, there are small but significant variances in the actual replacement cost provision, such as when the property is valued (at the date of loss or when it is actually replaced), whether or not the term new is used, and even whether the term like kind and quality is used.

Unsurprisingly, parties differ as to what constitutes like kind and quality. Moreover, outside influences may also affect replacement cost.

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Compliance with brand standards. One context in which like kind and quality is addressed is when an insured is required to comply with a “brand standard.” When a policyholder’s hotel suffers a loss and a portion of the hotel’s carpeting and wall covering finishes is damaged, there is often a conflict if the property owner is required to replace the materials in conformance with its management and operating agreement with the hotel management company’s current brand standard.

If the insurer is seeking coverage to replace both damaged and undamaged property, this may present a conflict under property insurance policies, which typically provide coverage only for property that has sustained direct physical loss or damage. Arguably, as a contract of indemnity, the policy should only cover the cost to replace the damaged material, despite the insured’s consequential contractual obligations to the brand.

Like ACV, the determination of replacement cost is ultimately a fact issue. Therefore, the issue of whether the updated material is of like kind and quality may be submitted to the factfinder. Practically speaking, the parties may reach an agreed-upon settlement concerning the amount of loss and include the cost to comply with the contractual requirement between the property owner/insured and its hotel management company.

Line of sight and damaged materials. Replacement cost disputes generally involve measurement issues, as opposed to coverage issues, which often do not require attorney input. Rather, adjusters and consultants working with insureds can typically resolve disputes without lawyers.

One legal issue that can arise, however, occurs when there is both damaged and undamaged property in a “line of sight,” potentially creating a mismatched appearance for the insured. Insureds may argue that simply repairing damaged property in an unmatched manner does not restore the insured’s property to its preloss condition.

One example of when this issue arises is in the context of roof or exterior finishes, where partial repairs create a change in appearance that the insured deems unacceptable. Selective replacement of roof shingles, for example, may result in an unmatched condition that is inconsistent with what the insured had prior to the loss. In order to restore the damaged building system (i.e., the roof) to its preloss condition, an insured often seeks replacement of the entire roof to create a matching roof system.

Line of sight questions also arise when damage occurs to interior public spaces, such as ballrooms and prefunction spaces, as well as hallways in hotels or apartment buildings where there is no apparent or acceptable break in the continuity of material. Other examples of matching concerns relate to partial replacement of cabinetry or furnishings.

In certain situations, there may be an opportunity to obtain enough undamaged roof tiles, carpet, or wall coverings from attic stock (additional construction materials stocked for the purpose of limited future repairs) to effect an acceptable result. These situations are not typical, however, and often the insured rejects that proposal, concerned about the longevity of the repair.

Ultimately, it is important to look to the policy language and applicable law. Some state insurance statutes effectively take the decision regarding partial repair versus replacement out of the hands of the parties. In other instances, building codes also may render the discussion moot. For example, in Florida, there is a building code that essentially requires full replacement of a roof system when damage and/or repairs exceed 25 percent of the roof surface. Similarly, the California Code of Regulations, which regulates claims practices and insurance policies, requires the insurer to replace all items in a damaged area to conform to a reasonably uniform appearance.

Recently, in Cedar Bluff Townhome Condominium Ass’n, Inc. v. American Family Mutual Insurance Co., the Minnesota Supreme Court found coverage for a claim to replace the siding of 20 buildings in order to ensure that the repairs ultimately “matched.” At least one siding panel on each of the 20 buildings at the insured’s condo complex was damaged by hail. Replacement panels were available from the same manufacturer with the same specifications but were not available in the same color. The policy provided coverage for replacement cost, which
was to be determined “based on the cost to replace the lost or damaged property with other property . . . of comparable material and quality.”²³ While acknowledging that comparable did not equate with identical, the court nevertheless determined that,

in accordance with the plain meaning of the policy language, we construe the phrase “comparable material and quality” to mean a reasonable color match between new and existing siding when replacing damaged siding.²⁴

Based on that analysis, the court ultimately concluded that an appraisal panel’s requirement for an identical match of all the siding was inappropriate.

Other courts have found no coverage for matching claims, however. For example, in Weiler v. Union Insurance Co.,²⁵ the court specifically stated that it would not consider the aesthetic condition of the property and rejected an insured’s claim for replacement of his house’s siding in its entirety. The policy in Weiler provided replacement coverage for “like construction and use.”²⁶

Based on these examples, there is no clear answer across jurisdictions as to whether a court would require matching undamaged property with damaged property. However, policy language is a fundamental consideration.

Obsolete parts and current modern equivalents. Due to the ever-changing technology associated with many types of equipment, it may be difficult to determine what constitutes like kind and quality when certain equipment is damaged. This situation arises in claims for production equipment, motor control centers, computers, and other electronic systems such as fire alarm panels. In this context, parties often measure replacement cost or the “current modern equivalent” based on manufacturer or consulting engineer recommendations.

Most issues arise when there is partial damage to an operating system or piece of equipment. Because technological improvements happen frequently, replacement parts or components for older systems often are not available. If available, they may be used or refurbished rather than new.

Repairing or replacing half a system may not be acceptable if the balance of the system is incompatible with the newer components. If the insured had a functional and reliable system prior to a loss, attempting to make new components work with older components may not restore the system to its preloss reliability, quality, and functional status. Therefore, there is an argument that the entire system should be replaced with a system of like kind and quality—i.e., the current modern equivalent—in order to make the insured whole. And although replacement with a like kind and quality current modern equivalent typically will provide a more modern system with more functionality (which is inherent in replacement cost), the cost of replacing all components may be less than the cost of a partial replacement.

The best way to address and avoid a potential dispute is by purchasing available insurance coverage that provides the insured with the option to replace the damaged equipment with new or modern equipment. This type of coverage is often available by endorsement and should be considered if the insured’s business relies upon sophisticated systems.

Replacement and new manufacturer specifications. In some cases, a damaged property system, such as a roof requiring repair, may no longer comply with a manufacturer’s specifications. For example, if a roof system damaged by the weight of ice and snow requires replacement, the roof membrane system may no longer be manufactured. A manufacturer can often provide a like kind and quality membrane system, but the manufacturer’s specifications for the roof deck with that new system may require a different deck than originally existed and tighter spacing of the mechanical fasteners.

This raises a conundrum for both parties. An insurer may question whether or not the additional cost of the roof deck and fasteners is an improvement that is reimbursable as part of the claim. An insured, on the other hand, may argue that the new membrane and deck system are like kind and quality given the manufacturer’s requirements. The insured may contend that similar manufacturer requirements likely were followed during the original installation and

Due to the ever-changing technology associated with many types of equipment, it may be difficult to determine what constitutes like kind and quality when certain equipment is damaged.
should be followed in the replacement scenario in order to achieve a proper repair. Ultimately, the parties may need to rely on their consultants and experts to determine the necessity of replacing undamaged property to meet new manufacturer specifications.

Another example of changing manufacturing specifications and modern design arises in the context of faulty material used in construction. As a hypothetical example, original Exterior Insulation and Finish System (EIFS)\(^{27}\) on a hotel’s exterior was damaged and required replacement. Although an accepted design at the time of the original installation, the “barrier” EIFS design was no longer accepted as a current design standard. The insurer’s project engineer designed a modern EIFS with drainage that was the currently accepted design standard for this type of system and also met the manufacturer’s current specifications. Though the new design incorporated features that corrected features in the original design, the insured maintained that it met the like kind and quality standard. The insurer, however, concluded that the new design was simply a code upgrade rather than a like kind and quality replacement. The resolution of this type of dispute requires experts and consultants to assist the parties in determining the proper repair to put the insured in the same position as existed preloss.

Fact issues and the need for reasonable claims. Clearing up the mystery behind the determination of like kind and quality varies based on the facts and circumstances of each claim. There well may be other provisions within the replacement cost provision or in other parts of the policy that affect the insured's recovery. However, with reference to like kind and quality, differences between the insured and the insurer often can be resolved with the presentation of reasonable, objective, and well-supported information demonstrating that the like kind and quality requirement has been satisfied. This information is necessary because, at the end of the day, it will be a fact issue for a jury to decide.

Valuation of Stock at ACV and Replacement Cost

Just as with property claims relating to real estate, valuation of business personal property also may be complicated. For commercial property claims, understanding the valuation of stock (also referred to as inventory) covered by the policy is key.

Confirming the type of stock valuation provision that is included in the policy should be one of the first steps in analyzing and assessing an insured’s stock claim. Generally, the most common available coverage options for valuation of stock are ACV, replacement cost, and net selling price.\(^{28}\) Typically, policyholders select replacement cost as the coverage for valuation. The policyholder may select ACV for the lower premium. Replacement cost typically reverts to ACV under a policy if the stock is not actually replaced. ACV is also the customary valuation of stock in the Standard Flood Insurance Policy General Property Form issued by the National Flood Insurance Program.

Definitions. ACV may be defined in a commercial property policy as “replacement cost less depreciation.” However, in the standard Insurance Services Office (ISO) CP 00 10 10 12 Building and Personal Property Coverage Form, ACV is not actually included in the definitions section. Instead, that policy specifies an option for "Replacement Cost (without deduction for depreciation) to replace Actual Cash Value."\(^{29}\) Hence, the definition provided for the replacement cost option in this particular standard form indirectly defines ACV. And, as noted above, when ACV is not defined in the policy, courts look to state law and precedent in defining the scope of ACV coverage.

Depreciation and stock valuation. Depreciation adjustments to arrive at ACV for stock valuation are less common than those applied to other business personal property items and buildings. Stock that is subject to quick sales turnover or with little variation in value may not require any depreciation adjustment, even when the stock is not actually replaced or the policy valuation is ACV. In other words, ACV for stock that normally is turned over (sold) quickly is often equal to optional replacement cost valuation because physical depreciation may not be applicable for items held for sale and not physically utilized. Another key consideration in policy language is whether the definition of ACV actually specifies physical depreciation or simply depreciation.

Depreciation, replacement cost, and obsolescence. In some cases, slow-moving stock and/or obsolescence for stock items may need to be considered relative to both replacement cost valuation and depreciation adjustments necessary to arrive at ACV. Obsolete stock refers to stock that is at the end of its product life cycle and has not seen any sales or usage for a significant or set period of time defined by its industry. For example, the computer and electronics industry has products that may be obsolete within a matter of years, if not months. As another example, an insured who retains a stock of VCRs, PalmPilots, and BlackBerrys will likely have stock obsolescence issues.

An insured also may have to comply with the “lower of cost or market” (LCM) rule under generally accepted accounting principles (GAAP) for financial reporting, which states that the business must record the cost of stock at

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27. EIFS
28. ACV, replacement cost, net selling price
29. Replacement Cost (without deduction for depreciation) to replace Actual Cash Value
30. Lower of cost or market (LCM) rule under GAAP
whichever cost is lower: the original cost or the current market price. Accounting transactional write-offs or write-downs of claimed stock in the insured’s books may need to be evaluated in considering obsolescence or market value declines.

As noted above, in some jurisdictions, ACV is sometimes defined as fair market value. Fair market value is what a willing buyer will pay to a willing seller. Other courts define ACV under the “broad evidence rule,” which considers replacement cost, fair market value, and any other factor that may assist a factfinder with determining the value of property.

Certain issues or scenarios that may arise with respect to replacement cost or ACV of stock include the following:

- Replacement cost information is not available as the item is no longer produced or available for purchase from suppliers in the marketplace.\(^{10}\)
- The insured’s current selling price of the stock item is less than replacement cost of similar stock in the marketplace.
- The insured’s original cost of the stock items is greater than the replacement cost of the stock, but the insured has elected not to actually replace the stock.
- The insured purchases varied closeout or discontinued items to resell as part of a “lot” purchase and does not have documentation to support the original cost of individual stock items. Further, the insured does not have the capability to repurchase the items as a lot in the marketplace as of the date of loss.
- Stock unit valuation may vary dependent on the volume of stock held by the insured. In other words, an individual unit price may not be the same when applying it to one unit lost or damaged compared to 10,000 units lost or damaged.

As always, the specific policy language will help to inform how the stock’s value should be assessed. For example, in the standard ISO CP 00 10 10 12 Building and Personal Property Coverage Form, the language for loss payment qualifies that the insurer will not pay the insured more than the insured’s financial interest in the covered property. This arguably limits the insured’s recovery.

Also, when stock is unique or obsolete, the parties may have to seek expert assistance in evaluating the replacement cost of damaged stock. Because ultimately the value of the stock is determined by a factfinder, it is unlikely that there is a clear or definitive answer to the obsolete stock valuation conundrum.

**Disasters: Impact on Labor Rates and Replacement Cost Valuation**

Following a widespread catastrophe or disaster, the ability of the average commercial policyholder to repair or replace damaged property may be challenged. The very nature of property insurance—coverage for an unforeseen and accidental loss—suggests that neither the insured nor the insurer can predict the precise costs related to a covered event. One particular cost that can be impacted greatly by a catastrophe is the cost of labor that will be required to complete the repair or replacement of the damaged property.

Following such large-scale events as Hurricane Katrina in 2005 and Superstorm Sandy in 2012 and, more recently, Hurricanes Harvey, Irma, and Maria, the impacted regions may experience “demand surge,” that is, the sudden and dramatic change in supply and demand for labor and materials. The demand increase typically is based upon the urgent need for qualified professionals, skilled labor, or other workers in the geographical area. The duration of the increase often depends upon the size of the region impacted and the ability of the labor market to respond with adequate resources. If the demand for labor exceeds regional capacity, demand and prices rise accordingly. In addition, importing labor into the affected region often results in additional costs for accommodation and travel.

The insurance industry attempts to understand this phenomenon in its catastrophic modeling. Data and predictive modeling companies provide insurers with models and analytics attempting to predict costs related to different perils. These models consider the impact of “loss amplification,” that is, how original (noncatastrophe) pricing is amplified as a direct result of the event. One industry expert explains how the insurance industry relies upon these models to predict loss amounts:

As frequently employed, the demand-surge component of a catastrophe model increases the calculated ground-up loss for a property. (The ground-up loss is the monetary cost to repair damage and continue operations, before applying insurance deductibles, copays, or limits.) A demand-surge factor multiplies the ground-up loss, either at the individual-property level or the portfolio level, by a factor, typically between 1.0 and 1.6. Depending on the model, this factor can be determined on the basis of the expected loss to
the insurance industry as a whole or on the basis of additional information, such as the affected region, peril, and type of property.  

Against this backdrop, claims preparers, adjusters, and auditors may need to consider the claim impact of a sudden rise in labor costs when calculating the ACV or replacement cost of the damaged property. Following a disaster, resorting to preloss pricing or estimating tools might not capture the actual labor costs required to make the repairs necessary to restore the property, thereby leaving the insured in a worse position than before.

The property policy does not attempt to itemize the costs and expenses that are covered by the policy, nor does it specify the amounts acceptable for each claim expense. Instead, the term reasonableness is often read into coverage, either expressly or implicitly. For example, the typical ISO property form requires the insured to act reasonably quickly following an event in order to claim replacement costs:

   d. We will not pay on a replacement cost basis for any loss or damage: . . .

   (2) unless the loss and damage are repaired or replacements are made as soon as reasonably possible after the loss or damage.  

In addition, most property policies require an insured to make actual repairs or replacement before claims can be asserted on a replacement cost basis. Obviously, the labor component of the reconstruction or repair costs thus would reflect actual labor rates.

Therefore, an insured should be entitled to recover actual labor rates as of the time the replacement or repair is completed, as long as the insured took steps to ensure that it was being charged a rate reasonable in the region at that time. That assessment, even if higher than ordinary labor costs normally realized in the region when no event occurs, will be considered reasonable given that the insured

Following a widespread catastrophe or disaster, the ability of the average commercial policyholder to repair or replace damaged property may be challenged.

is required to make repairs quickly following the damage. Requiring an insured to make repairs quickly following the event (in order to, inter alia, mitigate business interruption losses) but calculating labor rates without considering the impact of the event would be inconsistent with the policy.

ACV, Replacement Cost, and the Application of a Coinsurance Provision

Appropriately measuring ACV and replacement cost can affect more than just how much the insured recovers for property damage. The ACV/replacement cost measurement may also affect how certain policy provisions are applied. For example, depending on the policy language, calculation of deductibles may be based on the value of the insured property at the time of the loss. Similarly, these valuations may affect how a coinsurance provision is calculated—and, ultimately, the amount of the insured's recovery.

In the coinsurance context, some policies contain provisions that require the insured to value the insured property appropriately. These provisions are in place to prevent undervaluation in order to avoid higher premiums. A standard coinsurance provision may state thus:

   a. We will not pay the full amount of any loss if the value of Covered Property at the time of loss times the Coinsurance percentage shown for it in the Declarations is greater than the Limit of Insurance for the property:

Instead, we will determine the most we will pay using the following steps:

   (1) Multiply the value of Covered Property at the time of loss by the Coinsurance percentage;

   (2) Divide the Limit of Insurance of the property by the figure determined in Step (1);

   (3) Multiply the total amount of loss, before the application of any deductible, by the figure determined in Step (2); and

   (4) Subtract the deductible from the figure determined in Step (3).

We will pay the amount determined in Step (4) or the limit of insurance, whichever is less. For the remainder, you will either have to rely on other insurance or absorb the loss yourself.

The coinsurance provision reduces the insured's recoverable loss by multiplying the value
of covered property at the time of loss by the coinsurance percentage. But the policy does not specifically identify what value of covered property should be used, i.e., whether the ACV or replacement value of the insured’s business personal property is appropriate. If the ACV is used, the coinsurance provision’s effect on the insured’s claim may be reduced.

There is some guidance from courts addressing this specific issue. In State Auto Property & Casualty Insurance Co. v. Boardwalk Apartments, L.C., the Eighth Circuit found that the term value in the coinsurance provision meant replacement cost because “the replacement cost coverage is ‘inherently incorporated’ into the coinsurance provision.”35

Similarly, in Wenrich v. Employers Mutual Insurance Cos., the court examined whether the term value in the coinsurance provision should be calculated from the replacement cost or ACV of the insured property. The court found that the coinsurance provision was unambiguous and that replacement cost should be applied to calculate the coinsurance provision.36 Notably, the court recognized that the replacement cost “value” of the property, for purposes of calculating the coinsurance penalty, is a “mixed question of law and fact.” While the method of determining the valuation of the covered property is a question of law, the actual amount of the replacement cost of the insured property is a question of fact.

Because the value of covered property in the coinsurance provision contemplates replacement cost value, the cost of tax, freight, and installation arguably should be considered, too. Replacement cost coverage includes “any cost that an insured is reasonably likely to incur in repairing or replacing a covered loss.”38

Of course, the language of the policy itself is key, as are any state laws that may address measure of loss.

**The language of the policy itself is key, as are any state laws that may address measure of loss.**

**Conclusion**

The legal and practical issues involved in assessing replacement cost and actual cash value are manifold. Because issues of valuation are often at the heart of insurance claims and disputes, the ultimate calculation of replacement cost and ACV may be contentious. Reasonable practitioners, insureds, insurers, and consultants will recognize that the issues may be varied and look to the law of the applicable jurisdiction, as well as the advice of experts who have knowledge concerning the specific issues. Ultimately, as with most insurance issues, the best course to resolve any disputes likely will be the most reasonable one.

**Notes**

5. Id.
6. Id. at 783.
7. Id.
8. Id. at 758.
10. There were two claims and two policies under review in this matter. The second policy and claim were similarly measured.
13. Id.
14. Id. at 574.
15. Id. at 576.
19. Fla. Building Code § 708.1 provides thus:

   Not more than 25 percent of the total roof area or roof section of any existing building or structure shall be repaired, replaced or recovered in any 12-month period unless the entire roof system or roof section conforms to requirements of this code.

It is important to note in the Florida example that it is unlikely that replacement cost provisions will provide coverage for the enforcement of laws and ordinances that regulate the reconstruction of the damaged property (referred to as code upgrade coverage). It is highly recommended that policyholders purchase code upgrade insurance to supplement the replacement cost provisions of the insurance policy.

21. Cedar Bluff Townhome

22. Id. at 292.
23. Id. (citing policy (emphasis added by court)).
24. Id. at 294.
27. About EIFS, EIMA.com, www.eima.com/eifs (last visited Apr. 22, 2018): According to the definitions of the International Building Code and ASTM International, an Exterior Insulation and Finish System (EIFS) is a nonload bearing, exterior wall cladding system that consists of an insulation board attached either adhesively or mechanically, or both, to the substrate; an integrally reinforced base coat; and a textured protective finish coat.
28. The focus of this article is on issues germane to determining the replacement cost and ACV of damaged stock. Net selling price is typically more predominant amongst policyholders who have elected this valuation in lieu of business income coverage.
33. Id. at 13.
35. Id. at 517.
37. Id. at 587–91.
Contractual Indemnity
Anti-Indemnity Statutes and Additional Insured Coverage

By Gregory D. Podolak and Tiffany Casanova
Risk is an unavoidable factor in business transactions across all industries. It must be managed to ensure that it is limited. A common device utilized to manage risk is indemnity. Indemnity is a legal mechanism by which one party agrees to compensate another party for any loss, damage, or liability if a certain event or loss occurs. There are different forms of indemnification, including both common law and statutory; but for the purposes of strategic risk transfer in the commercial context, contractual indemnification is the most important.

Indemnification provisions and agreements are commonplace in contracts across all industries. The pervasive use of contractual indemnification in business transactions has resulted in state regulation called anti-indemnity laws. While the exact prohibitions of anti-indemnity laws vary by state, they generally prohibit one party from absorbing the sole negligence of another.

Additional insured coverage, a counterpart to contractual indemnification, has evolved into an equally important risk-transfer tool. Additional insured coverage is intended to function as a risk-transfer path parallel to contractual indemnity—both typically utilized in the same transaction. If one is unavailable, the other may serve as an adequate replacement. The development of anti-indemnity laws and the trend to utilize insurance and indemnity in conjunction have resulted in the application of anti-indemnity laws to additional insured coverage.

This article will provide a broad overview of contractual indemnification, anti-indemnity laws, and the emerging application of anti-indemnity laws to additional insured coverage. Those responsible for or interested in managing the risks of business transactions should develop an understanding of the types of indemnification, statutory regulation of indemnification, and the application of anti-indemnity laws to additional insured requirements. Awareness of the law and recent trends regarding anti-indemnity statutes will assist in contractual drafting, decreasing risk, and increasing recoveries.

### Contractual Indemnity

Contractual indemnity is a common risk-transfer tool utilized in many types of transactions that allows contracting parties to shift the risk between them as it relates to certain claims or losses. Indemnification contracts, or provisions within contracts, are used across all types of industries, including construction, transportation, and oilfield services. A typical indemnification arrangement is one-sided and involves an “indemnitor,” often a downstream party, promising to indemnify the “indemnitee,” an upstream party. While an indemnification agreement does not eliminate a party’s legal obligations as they relate to a loss, it does shift the financial obligations of a loss from the indemnitee to the indemnitor. The types of loss covered can be broad and depend on the language of the provision, but they often include bodily injury, property damage, claims, suits, and attorney fees.

There are many benefits to indemnity. Most significantly, indemnity typically shifts the risk to the party that usually is in a better position to manage it. For example, in the construction industry, an owner of property may hire a general contractor to construct a building. In turn, the general contractor enters into agreements with multiple subcontractors to construct the building. Each individual subcontractor likely has multiple employees responsible for various tasks at the project. A subcontractor would further contract with another subcontractor to take on a portion of its scope of services. At this juncture, the general contractor would be exposed to liability for loss from multiple points. If, however, in every agreement with each subcontractor, the general contractor included an indemnification provision, the risk of loss arising out of the relevant contract would shift to the individual subcontractor who is in the best position to manage each employee and the specific risks that come with its scope of work. The general contractor, who is more remotely positioned from the risks, has reduced its liability and spread the risks throughout the project participants.

Another benefit, at least from the perspective of the indemnitee, is that indemnification agreements might require the indemnitor to indemnify a third party that might not be a party to the contract but that could also face some risk related to the transaction. In the construction example provided, the indemnification agreement between the general contractor and the subcontractor would include the owner of the project as an indemnitee. Thus, if loss arose out of the contract, the subcontractor would indemnify both the owner and the general contractor.

Not all aspects of indemnification are beneficial. Indemnification has the power to be abused, shift more risk to a party than the party had control over, and create a moral hazard among upstream parties. The negative aspects of indemnification have led to legislative regulation of indemnification, as discussed later.

### Types of Contractual Indemnification Agreements

Though indemnification agreements often can go by different names and relevant language can vary dramatically from contract to contract, there are essentially three forms of indemnification: (1) limited form indemnification, (2) intermediate form indemnification, and (3) broad form indemnification. The more risk assumed by the indemnitor, the broader the form.

*Limited form indemnification.* Limited form indemnity occurs when the indemnitor agrees to indemnify the indemnitee for the indemnitor’s own negligence. In other words, the indemnitor only assumes the risk for its own sole negligence. This type of indemnity provides the least amount of protection to an indemnitee. There
is no protection for the indemnitee unless the indemnitor is 100 percent at fault. If any other party is involved in the loss, the indemnification agreement does not apply, and the indemnitor owes the indemnitee no indemnity.

Intermediate form indemnification. Intermediate form indemnity occurs when the indemnitor agrees to indemnify the indemnitee for the concurrent negligence of both parties. It is a more valuable risk-transfer mechanism than limited form indemnification because it is common for both parties to have played a role in causing the loss.

There are two types of intermediate form indemnification: full indemnification and partial indemnification. Full indemnification is when the indemnitor agrees to indemnify the indemnitee for all loss when both parties are at fault. To illustrate, an indemnitor who is 1 percent at fault must indemnify an indemnitee who is 99 percent at fault for 100 percent of the losses attributable to the claim. Partial indemnification is when the indemnitor agrees to indemnify the indemnitee only for loss attributable to the indemnitee.

TIP
Contracting parties must understand the intricacies of the anti-indemnity statutes and how they may impact their risk transfer, and must be prepared to adapt appropriately.

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In construction agreements, there is almost always an upstream party, such as an owner or general contractor, hiring a downstream party, usually a subcontractor or design professional. It became apparent that upstream parties, which were typically larger and more sophisticated, and downstream parties were not equipped with equal bargaining power; and downstream parties were often absorbing most of the risk, including for the upstream party’s negligence.

Therefore, 45 states have enacted construction anti-indemnity statutes. The limitations in construction anti-indemnity statutes vary by state. All states allow for the inclusion of limited indemnity provisions. Most states have prohibitions on broad form indemnity agreements but will allow some version of intermediate indemnification.

A few states do allow broad form indemnification if the agreement is clearly and unequivocally stated. These states do not have anti-indemnity statutes and are regulated solely by common-law jurisprudence. For example, in Alabama, in contracts between private parties, an indemnity agreement is enforceable as long as the intention to indemnify is “clearly indicated” in the contract and there is no evidence of unequal bargaining power.

Interestingly, there are a few states that statutorily sanction the use of broad form indemnity agreements. The agreements must meet certain requirements, such as inclusion within the bid documents, inclusion of a monetary limitation, or inclusion of a requirement to procure insurance to support the indemnity obligation.

Transportation anti-indemnity laws. The transportation industry follows the construction industry closely with respect to the enactment of anti-indemnity legislation. On a basic level, the transportation anti-indemnity laws function the same as the construction anti-indemnity laws: they impose limitations on the
indemnity assumed by the contracting parties. The rationale behind these laws in this industry is identical to that in construction: there was a need to protect downstream parties, like truckers and other motor carriers with little to no bargaining power, from absorbing most of the risk. To date, 45 states have enacted motor carrier transportation anti-indemnity laws.8

Generally, these statutes take one of two forms: (1) they prohibit requirements in indemnification agreements where the motor carrier must indemnify the non–motor carrier, usually a shipper or broker, for liability arising out of the non–motor carrier's negligent or intentional acts; or (2) they prohibit indemnification provisions in motor carrier contracts that have the effect of indemnifying an indemnitee for the indemnitee's negligent or intentional acts.9

Some states have implemented more nuanced transportation anti-indemnity statutes. For example, some limit indemnification for either party in both directions.10 In other words, both the upstream party and the motor carrier are prohibited from receiving indemnification for their own negligence. Some prohibit more than just indemnification for the parties' own negligent acts, such as the Alabama statute, which prohibits indemnification for the shipper for loss arising out of the criminal, intentionally wrongful, or wanton acts of the shipper; or latent defects of the product being shipped; or when property in the trailer is loaded and sealed by the shipper and unable to be inspected by the motor carrier.11

Notably, the motor carrier anti-indemnification laws do not apply to businesses or people who transport property incidentally to their primary business, such as a furniture store or restaurant that might provide delivery of furniture or food sold for a fee.12

Oilfield-services anti-indemnity laws. The rationale for the recent trend in implementation of oilfield-services anti-indemnity laws mirrors those of construction and transportation. Oil companies and well operators—upstream parties—entered into services agreements with smaller companies. Those agreements typically contained indemnification provisions that required the smaller companies to indemnify the upstream parties for liability arising out of the negligence of both the smaller parties and the upstream parties, including the sole negligence of the upstream parties. The smaller contractors faced significant liability that typically they were unable to insure due to cost and risk. This dynamic resulted in an unfair and unreasonable burden on smaller companies.

As a result, legislatures in jurisdictions where oilfield services are prevalent—Louisiana, New Mexico, Texas, and Wyoming—passed anti-indemnity acts to prohibit indemnifying an indemnitee for its own negligence or intentional acts.12

Some states have implemented more nuanced transportation anti-indemnity statutes. For example, some limit indemnification for either party in both directions.10 In other words, both the upstream party and the motor carrier are prohibited from receiving indemnification for their own negligence. Some prohibit more than just indemnification for the parties' own negligent acts, such as the Alabama statute, which prohibits indemnification for the shipper for loss arising out of the criminal, intentionally wrongful, or wanton acts of the shipper; or latent defects of the product being shipped; or when property in the trailer is loaded and sealed by the shipper and unable to be inspected by the motor carrier.11

Notably, the motor carrier anti-indemnification laws do not apply to businesses or people who transport property incidentally to their primary business, such as a furniture store or restaurant that might provide delivery of furniture or food sold for a fee.12

Louisiana, there is a similar exception for broad indemnification if the indemnification is supported by additional insured coverage and the indemnitee pays the associated costs of that coverage.19

Anti-Indemnity Statutes and Additional Insured Coverage

With the surge in anti-indemnity statute limitations came the need for upstream parties to diversify their risk-transfer efforts. Modern additional insured coverage emerged as a parallel risk-transfer path. Many contracts now include a requirement for the downstream party to procure additional insured coverage for the upstream party and related third parties, such as an ownership entity, in addition to indemnification agreements.

An additional insured essentially enjoys the same benefits of an insurance policy that the named insured does. As an example, in the construction industry, a general contractor might include a requirement for the subcontractor to procure general liability coverage for any liability arising out of the subcontractor's work and to name the general contractor and owner as additional insureds on said liability policy. The general contractor intends to be covered under the subcontractor's insurance policy for property damage and bodily injury liability that arises out of the subcontractor's work.

The question that eventually emerged is whether contractual insurance requirements to obtain additional insured coverage should be treated identically to indemnification requirements with respect to regulation and enforceability. Within the construction industry, courts and legislatures (see table on page 37) increasingly are assessing additional insured agreements in a manner similar to traditional contractual indemnification provisions, but the results are inconsistent.19 The results demonstrate the battle between “freedom of contract” and public
policy. Some courts have found that anti-indemnity statutes or principles do not apply to additional insured coverage requirements, while others find that they do, even when the relevant anti-indemnity statute is silent on the issue or seems to explicitly exempt insurance from its reach.

While this has not yet become an issue in the transportation and oil-field-services industries, the impact on the construction industry likely will have significant implications for other industries utilizing indemnification agreements that have their own set of indemnification laws. Participants in other industries should take note of the trends in the construction industry.

Application of Anti-Indemnity Laws to Insurance: Express Language

Some legislatures have attempted to clarify whether anti-indemnity statutes apply to additional insured requirements in contracts by expressly including language that dictates whether the statute applies to insurance requirements and/or policies.

Express application. Several anti-indemnity statutes expressly state that they apply to insurance requirements regarding liability for the sole negligence of the upstream party. They reason that an agreement to procure this type of insurance coverage violates public policy and is no different than an agreement to indemnify.

For example, Oregon’s anti-indemnity statute applies to both construction indemnification agreements and additional insured agreements. Specifically, it states thus:

\[\text{[A]ny provision in a construction agreement that requires a person or that person’s surety or insurer to indemnify another against liability for damage arising out of death or bodily injury to persons or damage to property caused in whole or in part by the negligence of the indemnitee is void.}\]

In Walsh Construction Co. v. Mutual of Enumclaw, the Supreme Court of Oregon reviewed an agreement between a subcontractor and a general contractor to procure additional insured coverage for the sole negligence of the general contractor. The court held that the requirement was no different than a direct requirement for the subcontractor to indemnify the general contractor for its sole negligence and that the limitations of the anti-indemnity statute thus applied. Consistent with the terms of the Oregon anti-indemnity statute, however, Oregon courts do not prevent a requirement for a subcontractor to procure additional insured coverage for a general contractor for the subcontractor’s negligence.

Like Oregon, several other states have gone a step further and included specific language in their anti-indemnity statutes to ensure the application of the statutes to insurance agreements. These states include Arizona, Colorado, Georgia, Kansas, Minnesota, Montana, New Mexico, Oklahoma, and Texas. Of these states, those that have confronted the issue have ruled in a manner identical to that of the Oregon Supreme Court.

Express denial of application. In the same vein, other anti-indemnity statutes expressly deny application of the limitations to insurance requirements in contracts. Consider the Missouri anti-indemnity statute as an example:

\[\text{[I]n any contract or agreement for public or private construction work, a party’s covenant . . . to indemnify or hold harmless another person from that person’s own negligence or wrongdoing is} \]

void as against public policy and wholly unenforceable. . . . [This] shall not apply to: . . . a party’s promise to cause another person or entity to be covered as an insured or additional insured in an insurance contract . . . .

This language is explicit and indicates that the anti-indemnity statute will have no bearing on an additional insured contract requirement.

Express language, diverse interpretations. More commonly, legislatures include language in the anti-indemnity statutes stating that the statutes shall not apply to any insurance contract. Courts nationwide have interpreted this language inconsistently or completely disregard its impact in analyzing whether the anti-indemnity statute applies to additional insured requirements in a construction contract.

In California, for example, courts consistently have held that this language means that this statute does not apply to requirements to procure additional insured coverage and does not bar an insurer from providing additional insured coverage for its sole negligence. Specifically, the California Court of Appeal reviewed the application of the California anti-indemnity statute with respect to a requirement to procure insurance and held that the specific language included in it, which reads “this section shall not affect the validity of any insurance contract,” demonstrated that the “clear import” of the anti-indemnity statute language has no impact on any provision requiring additional insured coverage. Furthermore, the court held that “it will not be deemed contrary to public policy or unenforceable merely because that additional insured party may have incurred claim liability due to its ‘sole negligence.’” Other jurisdictions with identical language in their anti-indemnity statutes have come to the same conclusion as California.
but on a distinct basis with little regard for the language in the statute. Like California, the Mississippi anti-indemnity statute states that “[t]his section does not apply to . . . insurance contracts or agreements.” Following an extensive analysis of the law in other jurisdictions on an issue of first impression, the U.S. District Court for the Southern District of Mississippi in Roy Anderson Corp. v. Transcontinental Insurance Co. held that an agreement to procure insurance is distinguishable from an indemnity agreement; and, accordingly, the anti-indemnity statute does not void the insurance requirement.

The court, however, included a caveat to this conclusion: the statute will apply to the agreement if the insurance requirement is linked to the indemnity agreement.

The distinction identified in Roy Anderson between insurance agreements that are linked to indemnification agreements and those that are not is significant as it is not uncommon for contracting parties to support an indemnity agreement with a requirement to procure insurance. Illinois courts, for example, have imposed a similar rule. The Illinois statute also states that it does “not apply to . . . insurance contracts or agreements.”

In Transcontinental Insurance Co. v. National Union Fire Insurance Co. of Pittsburgh, the court reviewed an agreement between a contractor and a subcontractor. The agreement contained both an indemnification provision and a provision that required the subcontractor to procure additional insured coverage for the contractor. The insurance requirement included a portion that stated that “the insurer shall insure Subcontractor’s obligations under Paragraph 17 and 18 herein.” Paragraph 18 contained the indemnification provision. The court determined that the insurance agreement and the indemnity agreement were “inextricably linked” to one another. Because of this, the anti-indemnity statute limitations applied to the insurance requirements. As a result, the court voided the insurance provision because it required the subcontractor, the indemnitor, to indemnify the contractor, the indemnitee, for the contractor’s sole negligence, violating the Illinois anti-indemnity statute, which only allows for partial indemnification.

Similarly, in Clarendon America Insurance Co. v. Prime Group Realty Services, Inc., the Illinois Appellate Court held that the anti-indemnity statute did not apply to requirements to procure insurance agreements that are not inextricably linked to indemnification agreements. There, the court reviewed a lease agreement between a commercial tenant and a building owner. The lease agreement contained a provision that required the tenant to procure general liability insurance for the landlord, as an additional insured, for bodily injury and property damage resulting from the tenant’s or landlord’s negligence. The agreement additionally contained an indemnification agreement that did not provide indemnification for the landlord’s negligence. The court held that nothing connected the promise to procure insurance to the promise to indemnify. Thus, the agreement to procure insurance was not subject to the limitations included in the anti-indemnity statute.

Other states have come to similar conclusions on the basis of a distinction between separate indemnity and insurance agreements and those that are inextricably linked.

Finally, one state, when reviewing nearly identical statutory language, came to the exact opposite conclusion, i.e., that the anti-indemnity statute does apply to requirements to procure additional insured coverage. The U.S. District Court for the District of New Jersey examined New Jersey law and held that the state anti-indemnity law, which prevents a party from being indemnified for its own negligence absent a “clear and unequivocal agreement,” is applicable to additional insured provisions despite the statutory language that seemingly exempts insurance from its reach. The court reasoned that any other outcome would result in “back-door attempt[s] at the statutorily prohibited result of indemnification for [an indemnitee’s] own negligence.”

Application of Anti-Indemnity Laws to Insurance: Silence

Not every anti-indemnity statute makes express reference to the application of its limitations to additional insured coverage. This silence renders the impact of anti-indemnity statutes on additional insured agreements in these jurisdictions unpredictable, unclear, or simply unknown.

For example, the Tennessee statute, on its face, does not make reference to insurance requirements; but, in one case, additional insured coverage was limited regardless. The court reviewed a contractual indemnity provision, determined that it did not comply with the anti-indemnity law, and reformed it. Then, in reviewing the insurance coverage available, it determined that the coverage available would be equally limited because the coverage was based on what was required in the “insured contract,” which was just reformed by the court.

Many anti-indemnity statutes are similar in form. Nevertheless, they are applied inconsistently to additional insurance requirements across jurisdictions and sometimes within a particular jurisdiction. The very different outcomes of the decisions discussed within this article demonstrate the general unpredictability in this field.
Best Practices: Anti-Indemnity Statutes and Contract Drafting

Contractors, their risk managers, and their counsel routinely rely upon contractual indemnity and additional insured coverage to transfer risk to downstream parties. As the complexities of anti-indemnity statutes continue to grow and, in some cases, overlap with additional insured considerations, both parties to the construction contract must appreciate fully how these intricacies will impact an effective risk-transfer structure and must be prepared to adapt appropriately. Below are important practices and considerations that should be adopted and applied by those in these roles.

Contractual indemnity agreement. When negotiating a contractual indemnity agreement, it is important for a party to consider its role in the transaction. An indemnification agreement that favors an owner is different from one that favors a subcontractor. Consideration of its role, combined with an understanding of the differences between the types of indemnity agreements, will allow a party to determine the type and scope of indemnity provision it should be favoring in negotiations.

Equally as important in the drafting phase is the need for a party to familiarize itself with the relevant anti-indemnity statute of its jurisdiction to ensure that the agreed-upon indemnification provision is compliant with it. For those entities operating on a national scale, a careful examination of choice of law principles—including public policy exceptions—will be equally critical. Not only does the drafter want to ensure that the provision grants indemnification only to the extent allowed by the statute, but also the drafter should be aware that some jurisdictions might require the inclusion of certain provisions, such as a monetary cap or an explicit allocation of the responsibility for the premium payment.56

Finally, it is vital to recognize the potential outcome of including a noncompliant indemnification provision in a contract. While some jurisdictions might reform the indemnity provision to give effect to the basic purpose of the contract, other jurisdictions void the indemnification agreement entirely for noncompliance.57 If the parties inadvertently include indemnification language that is broader than what is allowable by statute, a detrimental outcome could result. Both parties should consider qualifying the indemnification agreement with a “saving” clause, such as “to the fullest extent permitted by law.” Inclusion of this language is likely to prevent a court from pronouncing an entire indemnification provision void. It shows that the intent of the parties is to permit reformation of the indemnification agreement in the event that the indemnity clause included in the contract does not comply with the relevant anti-indemnity statute.58

Additional insured coverage requirement. Contractual indemnification is only one method of successful risk transfer. Inclusion of a requirement to procure proper sufficient additional insured coverage is also important. Requiring insurance not only is a way to assure that the other party to the contract has sufficient funds to fulfill its indemnification promises but also potentially serves as an alternative if contractual indemnification is unavailable.

After assessing the law of its jurisdiction, a party needs to take care that the insurance and indemnity agreements are not written such that they apply together or could be interpreted as such if this might be detrimental to coverage. As explained previously, certain jurisdictions, such as Illinois and Mississippi, will distinguish between insurance agreements that are inextricably linked to the indemnity requirement—to which a court would apply the anti-indemnity statute—versus those that are separate and distinct requirements.

Risk-transfer alternatives. Finally, it is worth considering potential risk-transfer alternatives in jurisdictions where anti-indemnity law specifically places constraints on contractual indemnification and additional insured coverage. Texas’s anti-indemnity law, for instance, specifically excepts owner-controlled and contractor-controlled wrap-up insurance programs from its reach.59 A wrap-up insurance program is a general liability program that is provided by the owner or general contractor but paid for by all of the parties enrolled in the program and meant to provide coverage for all parties enrolled. Thus, in Texas, the drafter of a contract should consider a wrap-up program in order to circumvent the restrictions of anti-indemnity provisions.

Conclusion

An important takeaway from this article is that anti-indemnity statutes may have a broader reach than those drafting contract agreements might anticipate. While many anti-indemnity statutes are similar in form, they are inconsistently applied to additional insurance requirements across jurisdictions and sometimes within a particular jurisdiction. The very different outcomes of the decisions discussed within this article demonstrate the general unpredictability in this field. This unpredictability warrants greater consideration than often is provided to indemnification provisions in contracts to ensure that risk is actually transferred. Those that are responsible for risk management must apprise themselves of their jurisdictional trends because failing to do so could be detrimental to the risk structure created.
## Construction Anti-Indemnity Statutes: Prohibition on Additional Insured Coverage Requirement?

### A State-By-State Review

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<tr>
<th>State</th>
<th>Statute</th>
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<td>LA</td>
<td>La. Rev. Stat. Ann. §§ 9:2780.1, 38:2216 (public contracts)</td>
<td>X No, provided that such coverage is only available when the indemnitor is partially at fault (private contracts).</td>
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Technically, no. But see Pa. Nat’l Mut. Cas. Ins. Co. v. Associated Scaffolders & Equip. Co., Inc., 579 S.E.2d 404 (N.C. Ct. App. 2003) (holding that insurer did not have to provide defense or indemnity when coverage was based only on “insured contract” and contract was deemed void by the anti-indemnity statute).


Notes
1. Indemnity, Black’s Law Dictionary (10th ed. 2014).
8. IRMI, Contractual Risk Transfer: State Motor Carrier Transportation Anti-Indemnity Statutes (Oct. 2017), www.irmi.com/online/crt/ch004/1104m-motor-carrier-transportation-anti-indemnity-statutes.aspx. (The website permits access only to those with IRMI accounts.)
language of the state permits a subcon-
1186 (D. Or. 2010) (holding that the
2005).
Stat. Ann. §§ 337.02, 337.05 (West 2002); Mont. Code Ann. § 28-2-2111
(West 2009); N.M. Stat. Ann. § 56-7-1 (West 2017); Okla. Stat. Ann. tit. 15,
§ 221 (West 2013); Tex. Ins. Code Ann. art. 151.104 (West 2009).
21. Walsh Constr. Co. v. Mut. of
E. 2d 1289
10th Cir. 2018) (holding that explicit
language of statute includes express
application to requirements to insure
for sole negligence of indemnitee);
Federated Dep’t Stores v. Superior Dry-
wall & Acoustical, Inc., 592 S.E.2d
485 (Ga. Ct. App. 2005) (holding that
indemnity clause purporting to indemnify
general contractor and owner for
their own negligence was void against
public policy, but the insurance clause
was not because it only required the
purchase of insurance for coverage for
liability resulting from the subcontractor’s negligent acts).
24. Id. at 1148–51.
1186 (D. Or. 2010) (holding that the language of the state permits a subcontractor to agree to indemnify against its
own negligence and that the indemnification and insuring agreement involved did just that).
Stat. Ann. §§ 337.02, 337.05 (West 2002); Mont. Code Ann. § 28-2-2111
(West 2009); N.M. Stat. Ann. § 56-7-1 (West 2017); Okla. Stat. Ann. tit. 15,
§ 221 (West 2013); Tex. Ins. Code Ann. art. 151.104 (West 2009).
27. See, e.g., First Mercury Ins. Co. v. Cincinnati Ins. Co., 882 F.3d 1289
(10th Cir. 2018) (holding that explicit language of statute includes express
application to requirements to insure
for sole negligence of indemnitee);
Federated Dep’t Stores v. Superior Dry-
wall & Acoustical, Inc., 592 S.E.2d
485 (Ga. Ct. App. 2005) (holding that
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was not because it only required the
purchase of insurance for coverage for
liability resulting from the subcontractor’s negligent acts).
(West 2012); Mo. Ann. Stat. § 434.100
25-21, 187 (West 2009).
(emphasis added).
Rptr. 2d 16 (Cal. Ct. App. 1999).
33. Id.
34. Miss. Code Ann. § 31-5-41
(2014).
35. 358 F. Supp. 2d 553, 567 (S.D.
Miss. 2005).
36. Id.
37. 502 So. 2d 500 (Fla. Dist. Ct.
1996).
38. 502 So. 2d 500 (Fla. Dist. Ct.
1996).
39. Id. at 503.
40. Id.
41. Id. at 506.
42. Id.
43. Id.
45. Id. at 14.
46. Id. at 9.
47. Id.
48. Id. at 14.
49. Id.
(explaining that there is a distinct difference between insurance agreements and indemnification agreements).
51. Shannon v. B.L. Eng. Generat-
ing Station, No. T-04-90, 2013 WL
6199173, at *19 (D.N.J. Nov. 27, 2013)
§ 2A:40A-1 (West 2010), that states that it “shall not affect the validity of any insurance contract” to hold any bearing
on a requirement in a contract to procure
additional insured coverage for the indemnitee).
52. Id.
53. Posey v. Union Carbide Corp., 507
54. Id.
55. Id.
56. See, e.g., Fla. Stat. § 725.06
(2001) (requiring certain monetary limitations on indemnification coverage available).
57. See Estate of Williams v. S. Ind.
Gas & Elec. Co., Inc., 551 F. Supp. 2d
751, 757 (S.D. Ind. 2008) (reforming an agreement to remove only broad form
indemnification).
58. See Brooks v. Jadlau Contracting,
(explaining that there is a distinct difference between insurance agreements and indemnification agreements).
(West 2009).
NEW KVAERNER ENDORSEMENTS REVIVE THE “OCCURRENCE” DEBATE—BUT WILL THEY WORK?

BY ERIC HERMANSON AND ANTHONY L. MISCIOSCIA
Commercial general liability (CGL) coverage for defective construction is like a tree with three limbs. At the root, following Professor Henderson’s seminal 1971 article, most courts agree that there should be no coverage for an insured’s own faulty work and that coverage should only be available to the extent the work causes damage to some other property.

But there is no consensus in the courts as to where in the policy this limitation appears. As a result, the case law divides into three branches:

• The first approach, exemplified by, e.g., Kvaerner Metals Division of Kvaerner U.S., Inc. v. Commercial Union Insurance Co., looks to the CGL insuring agreement, specifically, the section that says that the policy only covers liabilities caused by an “occurrence.” Occurrence, in turn, is defined to mean “an accident, including continuous or repeated exposure to substantially the same general harmful conditions.” In the view of these courts, there is no accident when an insured signs a contract—voluntarily agreeing to perform certain negotiated obligations—and fails to perform by delivering work that falls short of what it agreed. To allow an insured to sign a contract and then shift the costs of nonperformance to an insurer, these courts hold, would embrace moral hazard and would transform the CGL policy into a type of performance bond.

• The second approach, exemplified by Maryland Casualty Co. v. Reeder, also looks to the policy’s insuring agreement, specifically, the section that says there is coverage only when an insured faces liability for “property damage.” Property damage, in turn, is defined as “physical injury to . . . tangible property . . . or . . . loss of use of tangible property which has not been physically injured.” When an insured’s work is faulty and fails but does not cause other physical damage, these courts hold, the resulting lawsuit against the insured is effectively a suit for failure to meet contractual expectations. In such cases, the harm that the plaintiff is alleging is economic harm, not property damage to any tangible third-party property.

• The third approach, exemplified by the New Jersey Supreme Court’s recent decision in Cypress Pointe v. Adria Towers, holds that construction defects may qualify as “property damage” caused by an “occurrence” for purposes of CGL coverage as long as the defects were neither expected nor intended by the insured. These courts then look to the policy’s exclusionary language, e.g., the so-called business risk exclusions, to decide whether the policy extends coverage to such claims.

In general, insurers tend to favor the first two of these approaches. They prefer to treat “faulty work” claims as inconsistent with the fundamental purpose of liability coverage. By so doing, they cut off these claims at the threshold, under the broad language of the CGL insuring agreement, leaving no need to go further and determine whether exclusions preclude or limit coverage.

Insureds, by contrast, tend to favor the third approach—finding coverage unless an insurer can show that a policy exclusion limits or precludes coverage. The business risk exclusions in CGL policies can be complicated and difficult to understand. Many have significant carveouts and limitations, such as the subcontractor carveout to the “your work” exclusion. And once a claim is held to fall within a policy’s insuring agreement, it is the insurer, not the insured, that typically bears the burden of explaining these policy exclusions and persuading a court that the exclusions apply.

The Occurrence War
Over the last 30 years, as construction defect claims have proliferated, fierce battles have taken place between proponents of these competing approaches. In some states—the so-called Kvaerner states—insurers have prevailed. They have persuaded courts to find that faulty work is not property damage caused by an occurrence, and thus the exclusionary language that follows the insuring agreement should have no place in the analysis.

In other states, insureds have prevailed. They have persuaded courts that construction defects fall within the CGL insuring agreement as long as the defect arises without the insured’s expectation or...
foresee. In these instances, they have argued, coverage should turn on whether exclusions apply. General contractors, who often employ subcontractors to do much of the day-to-day work on a project, particularly tend to favor this approach. If a defect arises from a subcontractor’s work, they argue, the coverage case is effectively closed: based on the subcontractor carveout to the “your work” exclusion, they argue, the general contractor’s insurer should automatically cover the resulting defect claim.11

In a few states—Colorado, Arkansas, South Carolina, and Hawaii—courts initially ruled for insurers, holding that construction defects were not an occurrence. But legislators stepped in, enacting statutes that overruled the court decisions and declaring that defective construction might be a covered occurrence as long as coverage was not excluded elsewhere in the policy.12

The battle continues, and while the “strong recent trend” appears to favor coverage in at least some circumstances,13 a number of states continue to resist.14 The most prominent of the resisting states is Pennsylvania, which held in Kvaerner that CGL policies were written to cover tort liability for physical damage to others . . . not . . . contractual liability of the insured for economic loss because the product or completed work is not that for which the damaged person bargained.15

Thus, the court held that the definition of “accident” required to establish an “occurrence” under the policies cannot be satisfied by claims based upon faulty workmanship. Such claims simply do not present the degree of fortuity contemplated by the ordinary definition of “accident” or its common judicial construction in this context. To hold otherwise would be to convert a policy for insurance into a performance bond. We are unwilling to do so, especially since such protections are already readily available for the protection of contractors.16

Later Pennsylvania courts have repeatedly reaffirmed Kvaerner’s holding. Indeed, they have gone even further: extending the scope of the ruling beyond the repair and replacement of an insured’s faulty work, and finding any consequential damages that “naturally and ordinarily resulted from [a] breach” or “were reasonably foreseeable and within the contemplation of the parties at the time they made their contract” were excluded from coverage.17 The courts rejected insureds’ attempts to limit the doctrine to cases where no subcontractor’s work was involved18 or where the underlying action was pled in contract, not tort.19

The courts in these Kvaerner states really have the last word! Over the past several years, some insureds in these states have been taking a different tack. In an attempt to circumvent adverse judicial precedents, these insureds (through their brokers) have begun introducing “Kvaerner endorsements,” which alter the policy’s definition of occurrence or allow insureds to select the law of a different state to apply to the occurrence question. However, the endorsements themselves present significant issues, and their scope and enforceability remain to be tested in court.

**Occurrence definition endorsements.** One type of endorsement attempts to rewrite the CGL occurrence definition to specifically address the subcontractor exclusion to your work exclusion. There is no standard language for these types of endorsements, and various insurers have adopted different forms.

A typical example provides thus:

[N]otwithstanding any contrary law or decision, for purposes of coverage and the definition of “occurrence” under this policy, “property damage” in the form of physical damage to “your work” or arising out of it or any part of it and included in the “completed operations hazard” shall be deemed to be caused by an “occurrence” if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor.

A second version reads thus:

The following is added to the definition of “occurrence” in Section V., Definitions, but only for the purpose of determining whether property damage to Your Work caused by the work of one of your subcontractors is caused by an “occurrence” as defined under the Policy:

**Defects in “your work,” neither expected nor intended by any “insured” performed on your behalf by any subcontractor,**

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shall also be deemed an “occurrence.”

All other terms and conditions of the policy remain unchanged.

Unfortunately, both of these endorsements present significant interpretive difficulties. One major issue, present in both endorsements, is that the endorsements continue to assume the existence of property damage: specifically, “property damage to Your Work caused by the work of one of your subcontractors.” In both cases, the policy’s modified definition of occurrence applies only if (and to the extent that) such property damage is shown.

Can faulty subcontracted work, without more, be properly described as property damage for CGL purposes? As noted above, many cases suggest that it cannot. California, for example, already treats defects in construction, at least potentially, as accidental occurrences. Yet California courts do not automatically find coverage for defects in subcontracted work. Instead, they look to a second part of the policy: the definition of property damage, meaning “physical injury to tangible property or loss of use of tangible property that is not physically injured.” When a subcontractor’s work is faulty and fails, but causes no physical damage to any other part of the project, these courts find that the harm the plaintiff is alleging is economic harm, i.e., failure to deliver work that functioned as promised. The subcontractor’s work must cause damage to some other property—or, at a minimum, some work performed by a different subcontractor—before covered property damage can be found.

North Carolina follows a variation on this approach. It also bypasses the “occurrence” question and focuses on property damage, which it construes to mean—in the context of CGL policies—“damage to property that was previously undamaged.” Applying this definition, these courts hold that property damage does not include “the expense of repairing property or completing a project that was not done correctly or according to contract in the first instance” by the insured.

How would a court construing these endorsements in, say, Pennsylvania, treat such an argument? Because of the broad sweep of Kvaerner, most Pennsylvania courts have never had to confront the property damage question. Instead, these courts have rested their decisions on the threshold question of whether an occurrence exists. If a Pennsylvania court—accustomed to denying coverage for construction claims under covered property damage, there would still be no coverage for the tendered claims.

Most favorable state endorsements. A second type of endorsement, captioned “Most Favorable State Endorsement,” takes a different underwriting approach. This type of endorsement does not explicitly rewrite the occurrence definition. Instead, it opts to bypass it, allowing insureds in Kvaerner states to select a different law to apply to the occurrence issue.

One version of such an endorsement, which brokers have been promoting for use with insureds in Pennsylvania, provides as follows:

When the Named Insured is domiciled in the state of Pennsylvania, or has 50% or more of its operations in the state of Pennsylvania, or a claim or

Many cases suggest that faulty subcontracted work, without more, cannot be properly described as property damage for CGL purposes.
“Suit” is brought against an “Insured” in the state of Pennsylvania, the law of the state most favorable to the “Named Insured” shall govern whether “Property Damage” included within the “Products–Completed Operations Hazard” is caused by an “Occurrence,” for any “Insured” seeking coverage, provided that such state is a part of the United States of America including its territories and possessions; and

(1) has a substantial relationship to the “Named Insured,” or

(2) has a substantial relationship to the state in which such claim or “Suit” is brought; or

(3) is the state in which we are incorporated, or we have our principal place of business, or where this insurance contract was delivered to the “Named Insured.”

All other terms, conditions and exclusions remain unchanged.23

Notably, however, the choice of law provision in this case only applies to one specific issue, namely, the issue of whether “Property Damage” included within the ‘Products–Completed Operations Hazard’ is caused by an ‘Occurrence,’ for any ‘Insured’ seeking coverage. With respect to all other issues, a court construing the policy is free to apply the normal choice of law principles of the state where it sits.

It is, of course, not unheard of for parties to have different laws apply to different parts of a policy. There is even a name for this principle: dépeçage. For some years, directors and officers (D&O) carriers have made use of this approach, including choice of law clauses that try to bypass the application of state law that would otherwise disallow coverage for punitive damages.24

In the Kvaerner context, though, the application of dépeçage presents significant practical difficulties. One difficulty is in the limited phrasing of the endorsement: “whether ‘Property Damage’ included within the ‘Products–Completed Operations Hazard’ is caused by an ‘Occurrence.’” The phrasing suggests that a court must apply the named insured’s preferred law to the question of whether property damage is “caused by an ‘occurrence’”—but, before doing so, the court must apply a different law to the question of whether property damage exists. And, as previously noted, it is anyone’s guess how a Pennsylvania court—accustomed by Kvaerner to finding no coverage for these claims—would view the question whether a defect constitutes property damage in the first place.25

Moreover, even if an insured were to prevail on this issue, choice of law clauses do not apply automatically. Under the Restatement (Second) of Conflict of Laws, a court is free to deny the parties’ contractual choice of law when the application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue.26

The principle applies to insurance policies as it would to any other contract.27 Thus, applying this standard, some courts have

While the purpose of the new Kvaerner endorsements is to avoid adverse judicial precedent, it seems likely—at some point and in some context—that the endorsements themselves may need to be tested in the courts.
questioned the enforceability of D&O policy clauses allowing coverage of punitive damages.28

Might courts in Kvaerner states likewise question the enforceability of a Most Favorable State Endorsement if it required insurers to assume the moral hazard presented by contractors’ contractually assumed liabilities? The answer depends, in some measure, on whether those courts view Kvaerner as setting out a fundamental policy of the state in question. But there is support for such an argument if a litigant chose to make it.29

Finally, the endorsement leaves unclear how the parties (or a court) are to determine “the law of the state most favorable to the Named Insured.” Presumably, it should be the named insured’s responsibility to identify the law of the state that it wishes to adopt. But what if there are multiple named insureds under a policy? What if coverage is sought by a party other than the named insured? Must that insured defer to the named insured as to which law is selected? Particularly in construction claims, where multiple parties often seek coverage under the same policy, the likelihood of conflict is obvious and real.

The Likelihood of Future Litigation
No published cases have yet addressed these issues. The endorsements in question are very recent and have only begun to appear over the past few years. Moreover, in the current insurance market, some carriers may lack appetite to litigate these types of issues against their insureds.

However, as market conditions tighten, these commercial considerations may be weakened. Excess carriers, encountering this language in underlying primary policies, may have no compunction about taking a narrow view of the primary language. Reinsurers may challenge whether claims were properly paid under policies containing these endorsements if they believe the endorsements are unenforceable or do not apply.

While the purpose of the new Kvaerner endorsements is to avoid adverse judicial precedent, it seems likely—at some point and in some context—that the endorsements themselves may need to be tested in the courts.

Notes
2. 908 A.2d 888 (Pa. 2006).
3. Id. at 897.
5. Reeder, 221 Cal. App. 3d at 969.
7. The “your work” exclusion provides (in pertinent part) that CGL coverage does not apply to “[p]roperty damage to ‘your work’ arising out of it or any part of it and included in the ‘products—completed operations hazard.’” The “subcontractor exception,” introduced as part of the ISO 1986 policy form revisions, provides (in pertinent part) that the exclusion does not apply “if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor.” See, e.g., U.S. Fire Ins. Co. v. J.S.U.B., Inc., 979 So. 2d 871, 876, 879 (Fla. 2007) (concluding that the costs of repairing a subcontractor’s use of poor soil, improper soil compaction, and testing were covered under a liability policy).
11. Not true, of course. Insurance policies contain numerous exclusions. The subcontractor exception appears only in the exclusion for “your work,” discussed in supra note 7. A few lines away, in most standard-form policies, there is a similar exclusion for “your product,” to which the subcontractor carveout does not apply. A few lines farther is the “impaired property exclusion,” which applies to “impaired property,” defined as [t]angible property, other than “your product” or “your work,” that cannot be used or is less useful because: (a) [i]t incorporates “your product” or “your work” that is known or thought to be defective, deficient, inadequate or dangerous; or (b) [y]ou have failed to fulfill the terms of a contract or agreement; if such property can be restored to use by the repair, replacement, adjustment or removal of “your product” or “your work” or your fulfilling the terms of the contract or agreement.
The exclusion provides, in pertinent part, that there is no coverage for "[p]roperty damage" to "impaired property" or property that has not been physically injured, arising out of: (1) [a] defect, deficiency, inadequacy or dangerous condition in "your product" or "your work"; or (2) [a] delay or failure by you or anyone acting on your behalf to perform a contract or agreement in accordance with its terms.

Id. at 5. It is possible—and often occurs—that subcontracted work will be excluded from coverage by one of these other policy provisions, even if the subcontractor carveout means that the your work exclusion did not apply.

12. See Colo. Rev. Stat. § 13-20-808(3) (2010) (disapproving Greystone Construction, Inc. v. National Fire & Marine Insurance Co., 661 F.3d 1272 (10th Cir. 2011), and requiring that courts interpreting liability insurance policies "presume that the work of a construction professional that results in property damage, including damage to the work itself or other work, is an accident unless the property damage is intended and expected by the accident unless the property damage is intended and expected by the property damage or bodily injury resulting from faulty workmanship, exclusive of the faulty workmanship itself"); Haw. Rev. Stat. § 431:1-217(a) (2016) (responding to Group Builders, Inc. v. Admiral Insurance Co., 231 P.3d 67 (Haw. Ct. App. 2010), and providing that "the meaning of the term 'occurrence' shall be construed in accordance with the law as it existed at the time that the insurance policy was issued").


15. Kvaerner, 908 A.2d at 899 n.10 (quoting Henderson, supra note 1, at 415).

16. Id. at 899 (citations omitted).


18. Specialty Surfaces Int’l, Inc. v. Cont’l Cas. Co., 609 F.3d 223 (3d Cir. 2010). The developer in Gambone, 941 A.2d 706, also argued that an occurrence may be found, and coverage should be extended, where faulty work is performed by a subcontractor. It based this argument on the subcontractor exception to the your work exclusion and on the so-called reasonable expectations of the developer. The superior court rejected that argument, finding that it would require . . . coverage for claims predicated on warranties against instances of faulty workmanship performed by

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subcontractors. . . . [These] are not “occurrences” as a matter of plain language and judicial construction.


20. One interpretive difficulty specific to the second version of this endorsement is that it is not limited to products–completed operations claims and thus could be applied to ongoing operations, i.e., damages caused by a subcontractor’s work that require correction while the project is still being built. This is antithetical to how the subcontractor carveout generally works, and litigation may be necessary to ensure that the endorsement is given its intended (and narrower) meaning.


In the context of commercial general liability policies, the term “property damage” in the context of commercial general liability policies means “damage to property that was previously undamaged and does not include the expense of repairing property or completing a project that was not done correctly or according to contract in the first instance by the insured.”

23. The language of the endorsement tracks the choice of law language in section 187(2) of the Restatement (Second) of Conflict of Laws:

The law of the state chosen by the parties to govern their contractual rights and duties will be applied . . . unless either (a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties’ choice, or (b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue.

(Emphasis added).

24. A typical D&O clause of this nature provides thus:

[T]he definition of a claim includes punitive and exemplary damages, and the enforceability of this provision shall be governed by such applicable law that most favors coverage for such punitive or exemplary damages.

Weiss Global Solutions, The Insurability of Punitive Damages: A Primer 2 (July 2012) (emphasis added), available at www.willis.com/documents/publications/Services/Casualty/Punitive_Damages_Paper0712.pdf. The Willis source then notes, though, that “while regulators have approved it, the endorsement has yet to meet heightened scrutiny by the courts and therefore remains a mystery as to whether it will actually work.” Id. at 3.

25. See discussion supra.


27. See, e.g., Hartford Accident & Indemn. Co. v. Am. Red Ball Transit Co., 938 F.2d 1281 (Kan. 1997) (declining to apply Indiana law to insurance policy, under principle of lex loci contractus, where Indiana law allowed insurability of punitive damages and thereby “contravened[d] the settled public policy of [Kansas]” that “exemplary damages . . . awarded for purposes of punishment or deterrence . . . rest ultimately . . . on the party who committed the wrong”).

28. See Andrews Int’l v. Indian Harbor Ins. Co., 2013 U.S. Dist. LEXIS 141589 (D. Del. Sept. 30, 2013) (granting transfer of venue to California for consideration of most favored venue clause addressing punitive damages: “the parties appear to agree that the enforceability of such a provision presents an issue of first impression”).


The business risk doctrine is the expression of a public policy applied to the insurance coverage provided under commercial general liability policies. Reduced to its simplest terms, the risk that an insured’s product will not meet contractual standards is a business risk not covered by a general liability policy.

(Emphasis added).
Air Traffic Control Privatization

A Litigation Viewpoint

By Barry F. Benson
Opinions abound on the subject of whether Congress should privatize the nation’s air traffic control system. President Trump supports the idea: “After billions and billions of tax dollars spent, and the many years of delays, we’re still stuck with an ancient, broken, antiquated, horrible system that doesn’t work,” Trump said. ‘Other than that it’s quite good.” Others oppose it: “The federal government does two things well: national security and air traffic control. In fact, ATC is the [Federal Aviation Administration]’s best asset.”

Privatization of air traffic control is not a new idea. Over the years, legislation has been regularly proposed, without success, to transfer operation of air traffic services from the Federal Aviation Administration (FAA) to a private, not-for-profit corporation.

Amid the arguments over the pros and the cons, however, little discussion has been held on the impact of privatization on aviation accident litigation. Presently, the U.S. Department of Justice defends the United States in aviation tort lawsuits, including multidistrict litigation that arises following airline disasters.

Would privatization change the role of the U.S. government in aviation accident litigation? Privatization has already been implemented for nonradar towers under the FAA’s contract tower program. In litigation arising out of accidents at contract towers, courts have uniformly ruled that the United States cannot be held vicariously liable for the negligence of an air traffic controller who is an employee of an independent contractor. Furthermore, under the most recent failed proposal to transfer air traffic control services to a private corporation, the law would have provided that “the United States Government shall not be liable for the actions or inactions of the Corporation.”

This article examines the history of privatization of air traffic control facilities, discusses jurisdictional issues and the independent contractor exception, and analyzes the handful of cases where parties sought to hold the United States liable for the negligence of a private controller. The article also addresses the law on FAA designees, who are authorized to issue certificates on behalf of the FAA but are not FAA employees, and contemplates civil suits under privatization legislation.

**History of ATC Privatization**

In 1981, the Professional Air Traffic Controllers Organization, the union representing federal air traffic controllers, declared a national strike even though there was a no-strike clause in its contract. The FAA responded by firing more than 11,400 controllers; this decision was ultimately upheld in administrative proceedings and in the courts. The FAA was forced to operate its nationwide system with a much-dimensional workforce of approximately 3,500 remaining nonstriking controllers, supplemented by management personnel. It took the FAA more than three years to rebuild the controller workforce to close to prestrike numbers.

During the strike, the FAA closed 80 air traffic control towers and reduced the operating hours of others. It shifted experienced controllers from the closed towers to larger air traffic control facilities.

**Private contractors.** To reopen some closed towers, the FAA turned to private contractors. This was the beginning of the Federal Contract Tower Program. The FAA began with five tower locations to “determine the feasibility of contracting out certain towers and to gather data to assist the FAA in developing a national contract tower program.” The main focus of the program was to contract out towers that were then closed, although the outline of the program did contain plans to contract out 15 FAA-operated Level 1 towers.

Although there were discussions of canceling the program in its early years out of a concern that it was not economical, the FAA received a mandate from Congress in 1987 to continue the program. Acknowledging the FAA’s reluctance to continue the program, the House conference report stated that the “Conferees believe that the contract tower program provided significant benefits in terms of aviation safety, as well as economic development for participating communities.”

Ten years after initiating the pilot program, the FAA completed the “Level 1 Tower Staff Study,” which developed a plan to contract out 99 towers over four years, starting in 1994. The program has now grown to 242 towers in all 50 states and the federal territories. The FAA also contracted out the entire operation of Flight Service Stations—facilities that provide pilots with weather briefings and other pertinent flight information—to Lockheed Martin in 2005.

**Failed privatization bill.** The most recent air traffic control privatization bill would have continued the trend of defederalizing air traffic control by privatizing all air traffic services currently handled by the FAA. The bill contemplated a date on which all services, facilities, and infrastructure related to air traffic control would have been transferred from the FAA to the corporation. All contract tower agreements between the FAA and contract tower service providers would have been transferred as well. With respect to the corporation’s status as a government actor, the bill specified that the corporation would not be an instrumentality, agency, or department of the government and that all functions transferred to the corporation would no longer be functions of the government. The government would not have subsidized or funded the corporation. Rather, the bill authorized the corporation to fund its operations by collecting user fees from certain air carriers, chiefly airlines operating under 14 C.F.R. part 121 such as United, Delta, FedEx, and the like.
Jurisdictional Issues
The FAA’s air traffic control system may be a target for tort litigation following certain types of airplane accidents. What happens if the controllers are employees of a private company, however? Given that private corporations may have limited assets and insurance to pay for accidents, can plaintiffs seek to recover full damages from the government’s unlimited coffers in such a situation?
A plaintiff seeking to do so will face many hurdles, including the biggest hurdle in federal court: subject matter jurisdiction. Under the Federal Tort Claims Act (FTCA), a plaintiff can sue the United States for money damages . . . for injury or loss of property, or personal injury or death caused by the negligent or wrongful act or omission of any employee of the Government while acting within the scope of his office or employment.\(^{18}\)

If a claim does not fall squarely within these parameters, though, the federal courts lack jurisdiction.

Independent contractor exclusion. One area in which the federal courts lack jurisdiction is the realm of independent contractors. The Supreme Court explained thus:

Since the United States can be sued only to the extent that it has waived its immunity, due regard must be given to the exceptions, including the independent contractor exception, to such waiver.\(^{19}\)

The FTCA defines employee[s] of the government as “officers or employees of any federal agency.”\(^{20}\) In turn, federal agency means the executive departments, the judicial and legislative branches, the military departments, independent establishments of the United States, and corporations primarily acting as instrumentalities or agencies of the United States.\(^{21}\)

The key to the independent contractor exclusion of the FTCA is found at the end of the definition of federal agency in 28 U.S.C. § 2671, which specifically excludes “any contractor with the United States” from the definition.\(^{22}\) The clear import of these definitions is that a contractor is not an employee of the government under the FTCA, so a contractor’s negligence does not give federal courts subject matter jurisdiction over a suit against the United States.

Limits on control of the contractor. The key factor in determining whether an entity is a contractor under the FTCA is the “absence of the authority in the principal to control the physical conduct of the contractor in performance of the contract,”\(^{23}\) such as details of the “day-to-day operations.”\(^{24}\) This connection between lack of control and independent contractor status holds true even if the government agency sets detailed rules and regulations in the contract. In the context of a contract for prison operation, the Supreme Court discussed the detailed rules and regulations that the Bureau of Prisons required the contractor to follow. The rules specified “standards of treatment” for prisoners, “including methods of discipline, rules for communicating with attorneys, visitation privileges, mail, medical services, and employment.” These rules did not convert the contractor’s employees into federal employees, however:

[T]he agreement gives the United States no authority to physically supervise the conduct of the jail’s employees; it reserves to the United States only “the right to enter the institution . . . at reasonable hours for the purpose of inspecting the same and determining the conditions under which federal offenders are housed.”\(^{25}\)

Case holdings. The U.S. Supreme Court has uniformly upheld the FTCA’s contractor exclusion. The seminal cases are Logue v. United States and United States v. Orleans.\(^{26}\) In Logue, the Court noted with interest that Congress did not leave the independent contractor exclusion to be determined by state law as it did with other aspects of liability under the FTCA. By incorporating the exclusion directly into the FTCA, Congress made the contractor exclusion a strictly federal issue.\(^{27}\) The agency laws and exceptions of individual states do not apply.

Contractor Exclusion and Case Law
The United States has successfully invoked the contractor exclusion in many cases, including aviation-related cases. In looking at the heavily regulated aviation system, courts have ruled that the United States is not liable for the negligent acts of private controllers or private persons who have been delegated certain regulatory authorities.

Two sets of plaintiffs have sought to hold the United States vicariously liable for a contract controller’s negligence. Both cases were brought in federal court in the U.S. District Court for the Northern District of Illinois and appealed to the U.S. Court of Appeals for the

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Traffic Control, Inc.28 The airplanes services provided by Midwest Air the United States for the alleg- midair collision near Chicago sued of seven passengers who died in a case, the estates the Seventh Circuit. Both cases resulted in a judgment for the United States, and both were affirmed on appeal to the Seventh Circuit.

Alinsky v. United States. In Alinsky v. United States, the estates of seven passengers who died in a midair collision near Chicago sued the United States for the allegedly negligent air traffic control services provided by Midwest Air Traffic Control, Inc.28 The airplanes were receiving services from Midwest’s controller at the Meigs Field Control Tower. The Northern District of Illinois granted summary judgment in favor of the United States on several claims, finding that the controller was an employee of an independent contractor and thus not a federal employee. The court ruled in favor of the United States on the remaining claims at trial. The trial court's decision was affirmed unanimously by the Seventh Circuit.

In their complaints, the Alinsky plaintiffs alleged that the United States was vicariously liable for the negligence of the contractor. They also alleged negligence in the terms, nature, and administration of the contract to provide air traffic control services, and in the FAA’s oversight of the contract in its role as an industry regulator.

The United States moved to dismiss the case. Judge James B. Zagel granted the motion in part, ruling that Midwest was an independent contractor under the FTCA.29 The court relied upon the declaration of the manager of the Contract Tower Program at FAA headquarters, along with the plaintiffs’ own characterization of Midwest’s contractual relationship with the FAA.

Some of the reasons for the court’s ruling were as follows: The FAA did not control the day-to-day operation of Meigs Tower. Midwest was an independent corporation headquartered in Kansas. Midwest hired and fired and supervised its employees. Midwest set its controllers’ salaries and decided their benefits. The FAA had no control over Midwest’s finances. The court also noted that, after an initial start-up period, the FAA gave Midwest complete dominion over training and quality-assurance initiatives.30

The Alinsky plaintiffs argued that the FAA should be considered the de facto employer because, under the contract, the FAA retained power to designate hours of operation, set the qualifications of Midwest’s workers, choose the type of equipment used, and fire any of its employees. The court rejected this argument:

Courts have ruled that the United States is not liable for the negligent acts of private controllers or private persons who have been delegated certain regulatory authorities.

The fact that the FAA had a certain amount of oversight over Midwest does nothing to dispute the government’s assertion that day-to-day management of the Meigs Field Air Tower rested entirely with Midwest. Midwest is quite clearly a contractor within the meaning of 28 U.S.C. § 2671. As such, the negligence of its employees is no basis upon which to hold the United States vicariously liable.31

Judge Zagel left two narrow issues for trial. First, did the FAA unreasonably delay a contract modification for Midwest to increase staffing at Meigs Tower? Second, was a certain FAA manager properly qualified to conduct Midwest’s initial phase-in period, when Meigs Tower was converted from an FAA-operated facility to a contract facility?32 At trial, the court ruled that the United States had not acted negligently and that the plaintiffs’ remaining allegations fell within the “discretionary function” exception to the FTCA, 28 U.S.C. § 2680(a). The court granted judgment in favor of the United States.33

The plaintiffs appealed on several grounds. They argued that the United States had a nondelegable duty under Illinois law to provide air traffic control services and was thus responsible for the controller’s negligence. They also contended that the United States was liable for allowing an allegedly untrained and unqualified controller to work at the tower. They further contended that the United States negligently delayed approving additional staffing at the tower.

The circuit court first considered the independent contractor exclusion, citing the seminal cases of Logue and Orleans. Because the controller worked for Midwest, an independent contractor, the court concluded that, “under the FTCA, the district court lacked jurisdiction to consider any claims against the United States based on [the controller’s negligence].”34 The court rejected the plaintiffs’ argument that the FAA lacked authority to enter into contracts for air traffic control services, citing 49 U.S.C. § 40110. The court also rejected the plaintiffs’ arguments based upon Illinois’s nondelegable duty doctrine: “[I]n adopting the FTCA’s contractor exception to liability, Congress did not simultaneously adopt the various state exceptions to the independent contractor rule.”35 Because the United States did not adopt state law exceptions, Illinois’s nondelegable duty doctrine did not apply, and

the plaintiffs’ attempts to hold the United States liable for [the controller’s] conduct fail because
she was an employee of Midwest, a private contractor, and not the United States.36

The court also rejected the plaintiffs’ arguments that the FAA should have required a higher level of staffing at the Meigs Tower or approved a request for increased staffing faster than it did.37 Furthermore, the court held that the FAA’s oversight of the contractor fell within the discretionary function exception.38

Thus, the discretionary function exemption protects the government from liability for claims premised on the lack of training, oversight, or qualifications of air traffic controllers, since the government acted within its discretion to contract those responsibilities out to Midwest.39

Therefore, in the first case to attempt to hold the United States liable for the negligence of an air traffic controller employed by a private company, the decision resulted in no liability for the United States.

Collins v. United States. While the Alinsky case was still making its way through the courts, the second contract tower lawsuit was filed, also in the Northern District of Illinois. The Collins case arose from a midair collision near Waukegan Regional Airport, Illinois, in February 2000. This case attracted local media attention because one of the pilots was Bob Collins, a popular morning radio host for WGN-AM radio in Chicago. Two other pilots died in the accident, which also caused substantial damage to a private cancer treatment center on the ground. As in the Alinsky case, the controller was an employee of Midwest (called Midwest Air Traffic Control Services in the Collins case). Waukegan was operating under the same exact contract as Meigs.40

Despite the similarities to Alinsky, trial judge John W. Darrah denied the United States’ pretrial motions to dismiss, and the case proceeded to a three-week trial in 2007. After trial, the court entered judgment in favor of the United States.41

The court resolved most factual issues in the plaintiffs’ favor. It found that the controller was negligent and that his negligence was a proximate cause of the accident. On the contractor issues, the court held that the FAA exerted control over the contractor, including requiring certain training, requiring contract controllers to follow FAA rules, controlling the hours of operation, requiring contract controllers to meet certain minimum qualifications, etc. The contract detailed the requirements set by the FAA:

[It] would appear that the contract here established the authority of the FAA to control the physical conduct of Midwest in the operation of the WRA Tower at the time of the midair collision.42

The court concluded, however, that it was bound by the Seventh Circuit’s decision in Alinsky that Midwest is an independent contractor:

[It] is uncontested that the same contract provisions that Plaintiffs rely upon to demonstrate the day-to-day control necessary to make Midwest a Government employee were present in the contract before the Alinsky court,

which determined Midwest was an independent contractor pursuant to that agreement.43

Thus, based on the precedential effect of Alinsky, the court ruled that the United States could not be held vicariously liable for the controller’s negligence.

The court also ruled in the United States’ favor on the plaintiffs’ remaining allegation, i.e., that the FAA should have installed a tower radar display in the Waukegan Tower before the accident. The court held that the FAA had been negligent in not installing the radar display earlier but that such equipment-allocation decisions are not actionable because they fall within the discretionary function exception of the FTCA.44

The Collins plaintiffs appealed their loss to the Seventh Circuit. They argued that Alinsky did not truly litigate the contractor issue and should not be binding on them because this issue was dismissed in Alinsky on summary judgment before trial and not further pursued in the trial or appeal. They contended that the FAA was so controlling of how the contractor must operate the control tower that it was a de facto FAA tower for purposes of tort liability, and that the FAA’s decisions about installing radar display equipment were not discretionary functions because they were based on political rather than safety or policy considerations.45

The court of appeals rejected the plaintiffs’ arguments and dismissed the appeal. The opinion, written by Judge Richard A. Posner, affirmed the district court’s holding that the plaintiffs’ claims were barred under the independent contractor and discretionary function exceptions to the FTCA. The court declined to revisit its prior opinion in Alinsky on the contractor issue and held that the FAA’s decisions prioritizing the expenditure of funds for the purchase of radar equipment were “quintessentially”
a discretionary function and therefore outside the jurisdiction of the courts.46 Postdecision motions for en banc review were unsuccessful, and the Collins case remains the last word on federal responsibility for FAA contract towers.

The FAA’s Delegation Program
Somewhat similarly, courts long have held that the United States cannot be held liable for the negligence of private persons who have been delegated authority to issue aviation certificates: in the last four decades, courts have ruled consistently that the United States cannot be held liable for the negligence of a designee. It is thus a safe bet that if Congress ever did privatize all air traffic control functions, the tort liability would fall on the corporation itself and not on the United States.

History of delegation program.
For nearly a century, the FAA has promoted a public-private partnership that allows the aviation industry and community to self-regulate by giving certain private persons the authority to conduct inspections and pilot examinations and to issue certificates. By allowing private persons to issue engineering, airman, airworthiness, and medical certificates, the FAA has been able to stay within its budget while still setting safety standards for the growing aviation community.

The FAA has been using private persons to act as designees since 1927, when the Federal Air Surgeon designated private physicians to conduct aeromedical physical examinations.47 This designation program worked so well that designee programs now exist in numerous fields, such as certificating aircraft, engineering, manufacturing, pilot testing, and more. The program expanded to pilot examiners in 1940, when the FAA’s predecessor agency, “pressured by the rapid growth of the Civilian Pilot Training program,” introduced

“spot checking” of pilot training, permitting flight instructors to certificate pilots. The CAA [Civil Aviation Authority] could then limit itself to checking on the instructors, their schools, and one or two pilots from each group of trainees.48

As historian John Wilson explained, thus began

what came to be known as the designee program—the practice of delegating a part of the certification process to the industry itself. It would prove to be in the long run a successful experiment in self-regulation.49

The authority to delegate FAA certificate functions to private persons is now codified at 49 U.S.C. § 44702(d)(1).

Rulings on cases involving designees. One of the first cases to consider whether the United States could be held liable for the negligence of a designee was Charlima v. United States, appealed to the U.S. Court of Appeals for the Eighth Circuit in 1989.50 In that case, the court of appeals, affirming the district court’s grant of summary judgment on another ground, held that a designated airworthiness representative (DAR) was not a federal employee. The court considered it pivotal that the FAA did not control the day-to-day actions of the DAR.51 In addition, the FAA had no contractual relationship with the DAR, and he was not on the FAA’s payroll or otherwise compensated by the FAA. The Eighth Circuit reasoned that holding the United States liable for the actions of an FAA-designated representative would impermissibly stretch the definition of government employee under the FTCA beyond the outer boundaries intended by Congress in drafting that legislation.52

The U.S. Court of Appeals for the Second Circuit reached the same conclusion the next year in Leone v. United States.53 In that case, the estates of two passengers killed in a plane crash when the pilot suffered a heart attack attempted to hold the United States liable for an FAA-designated private physician’s failure to discover the pilot’s heart disease.54 The Second Circuit reversed the lower court’s holding that private physicians designated as aviation medical examiners (AMEs) were “employees of the government” and were “acting on behalf of the government” for FTCA purposes.55 The court based its decision on the application of the “strict control” test,56 finding that the “question is not whether a contractor must comply with federal regulations and apply federal standards, but whether its day-to-day operations are supervised by the Federal Government.”57 Therefore, despite the fact that the FAA acted as a general overseer of the AMEs, the court held the United States was shielded from liability because the FAA did not “maintain control over the detailed physical performance of the AMEs.”58 The court further noted that the FAA did not provide the AME in this case with compensation, insurance coverage, or other fringe benefits.

These cases show that the United States does not remain liable after delegating certain regulatory activities to private persons. Because the United States does not employ designees, it is not liable for them, just as it is not liable for the negligence of air traffic controllers who are employees of private companies. Had the FAA decided to conduct every flight physical by itself, for example, it would have needed to keep a larger number of doctors on its payroll and would have assumed the tort liability that comes with being an employer. The same would be true for aviation engineers and pilot examiners.

Civil Suits under a Privatization Regime
If the air traffic control system were privatized completely, how would litigation play out? A look at the
recently failed privatization bill, rules about U.S. liability for independent negligence, and recent litigation against private air traffic controllers gives some indications.

**Recently failed privatization bill.** With respect to the most recent bill to privatize air traffic control, which is no longer under consideration in Congress, the private corporation could have been sued and held liable under civil law, and the United States would not have been liable for the actions or inactions of the corporation.

If such a bill ever did become law, any such private corporation would find itself lacking some of the key defenses that the United States uses to defend air traffic control lawsuits. For example, aviation tort suits against the United States must be tried before a judge, without a jury. Lawsuits against a corporation presumably would be tried before juries, with no damages cap or other protections against prejudgment interest, punitive damages, or attorney fees (which do not apply to the United States).

Under the failed bill, the corporation would have been required to be insured, but the bill did not specify any further details, such as the amount of insurance required or whether the United States would have provided any supplemental guarantees like the risk sharing available for commercial space launch ventures. The corporation itself thus would have been a defendant in any lawsuit arising out of negligence by one of its controllers, just like the situation with independent contractors in the contract tower litigation.

**U.S. liability for independent negligence.** The United States can be sued for its independent negligence. Thus, if litigation arises for negligence at a future private air traffic control facility, the United States possibly could be sued for negligent actions of any remaining FAA employees. FAA employees are likely to remain in fields such as aircraft and pilot certification and installation and maintenance of navigational aids. Such policy-based regulatory actions tend to fall within the discretionary function exception to the FTCA, however, in which case the United States would not be a proper defendant.

In at least two cases involving contract towers, the plaintiffs have sued the United States and the contractor separately, not seeking to hold the United States vicariously liable for the contractor's share of the negligence.

After the Korean Airlines Flight 801 crash in Guam, the plaintiffs sued the United States for alleged negligence at the FAA's radar facility and sued the contractor, Serco, Inc., for the alleged negligence at the contract tower. The case was complicated by issues involving international law, the Warsaw Convention, and the liability of Korean Airlines. Most of the individual cases were settled after all three defendants (the United States, Serco, and Korean Airlines) entered into a sharing agreement that delineated separate contributions to be made by each defendant to satisfy the plaintiffs' claims.

In Swanson v. United States, in federal court in Florida, the plaintiffs originally sued the United States for alleged negligence by the FAA in controlling air traffic. They also alleged that the instrument landing system was defective. Upon notification that the tower at issue, Craig Tower, was operated by Robinson Aviation Inc., a private company under contract to the FAA, the plaintiffs amended the complaint to sue Robinson, as well. They maintained their allegations against the United States for alleged negligence of federal employees but switched the allegations of negligence at the Craig Tower to Robinson Aviation. The case was settled before trial.

**Litigation against private air traffic controllers.** Jury trials can result in high verdicts in sensational and tragic aviation cases, including those against private air traffic controllers. For example, in 2013, a jury returned a verdict of $100 million in an aviation personal injury action brought by a pilot against a contract tower, Robinson Aviation Inc., finding Robinson's air traffic controller responsible for 68 percent of the fault. In 2017, a jury awarded $17 million in Maryland for two deaths from a plane crash near Frederick Municipal Airport in 2014, blamed on the contractor operating the tower. The defense of these lawsuits is handled by private law firms, not the U.S. Department of Justice.

**Conclusion**

Air traffic controllers sound the same, and apply the same procedures, whether they are employed by the FAA, the military, or a private contractor. This undoubtedly will be true if a law is ever passed to privatize major air traffic control facilities. Given the history and the case law, though, the United States most likely would not be responsible for paying damages for negligence of an air traffic controller working for a private corporation.

**Notes**


5. Id. at 878.
6. Id.
13. Id. § 211 (proposed 49 U.S.C. § 90302, directing secretary of transportation to transfer; § 90316, providing for transfer of federal personnel; § 90317, providing for transfer of facilities, equipment, and property).
14. Id. (proposed 49 U.S.C. § 90703(a)).
15. Id. (proposed 49 U.S.C. § 90304(a)).
17. Id. (proposed 49 U.S.C. § 90313(a)).
19. United States v. Orleans, 425 U.S. 807, 814 (1976) (holding that employees of a nonprofit organization that received funding from the United States were not federal employees for purposes of the FTCA).
21. Id.
22. Id.
27. Logue, 412 U.S. at 528–29 (holding that employees of a county jail that housed federal prisoners pursuant to a federal contract were not federal employees and, thus, that the United States was not liable for their torts).
30. Id.
31. Id.
34. Alinsky v. United States, 415 F.3d 639, 644 (7th Cir. 2005).
35. Id. at 645.
36. Id.
37. Id. at 646–47.
38. Id. at 647–48.
39. Id. at 648.
40. The Contract Tower Program at FAA headquarters in Washington, D.C., issued one uniform contract, with separate options exercised for each individual tower. This was a five-year contract and was in place at the time of both the Meigs and the Waukegan accidents.
42. Id. at *18.
43. Id.
44. Id.
45. Collins v. United States, 564 F.3d 833 (7th Cir. 2009).
46. Id. at 839.
49. Id. at 24.
50. Charlima, Inc. v. United States, 873 F.2d 1078 (8th Cir. 1989).
51. Id. at 1081.
52. Id. at 1081–82 (explaining that a contrary reading would "make the Government a joint insurer of all activity subject to safety inspection").
54. Leone, 910 F.2d 46.
55. Id. at 47 (citing lower court decision, Leone, 715 F. Supp. 1182, 1190 (E.D.N.Y. 1989)).
56. Id. at 49–50.
57. Id. at 50.
58. Id.
60. Id. (proposed 49 U.S.C. § 90304(b)).
SAFETY IN FLIGHT

WHEN CAN COMMERCIAL AIRLINE PILOTS REMOVE PASSENGERS WHO MAY BE A THREAT?

By Oliver Beiersdorf and Catherine E. Kiernan
n May 2018, a woman was removed from a Spirit Airlines flight from Atlanta to Las Vegas because she allegedly ran past a gate attendant after being told she was too late to board, refused to leave the plane when asked by the flight crew, and screamed profanities at the flight crew. Ultimately, all of the other passengers had to deplane before officers could escort the woman off of the plane. All of this occurred while the pilots were focusing on completing preflight checks and preparing the aircraft for takeoff to ensure a safe flight. This incident, like many others where passengers are removed from commercial flights, was recorded, posted on social media, and highlighted by various news organizations. The woman removed from the Spirit Airlines flight streamed the entire event via “Facebook Live,” and the video has been viewed more than 4.5 million times on Facebook alone.

With heightened social awareness regarding the safety of commercial flight as well as evolving airline regulations, it is critical that a pilot in command have the authority and discretion to remove passengers who may be a threat to safety. An airplane in flight is a unique environment with special risks, and a pilot in command often must make quick decisions based solely on information relayed from other crew members. While the public may be able to watch a video of a situation on a plane that results in a passenger’s removal multiple times and consider alternatives and outcomes in hindsight, pilots and flight crew have to react in real time to ensure the safety of all passengers in an enclosed environment while flying thousands of feet in the air.

Congress, by statute, explicitly gave safety the highest priority in air commerce, and the Federal Aviation Act (FAA) includes a provision providing the pilot in command with broad authority to remove passengers that are or may be a threat to safety. The Tokyo Convention provides pilots in command with similar discretion on international flights, although the limited case law interpreting the Tokyo Convention provides a less deferential standard. This article discusses (1) the rights of air carriers to exclude or refuse to accept passengers on domestic and international flights under § 44902(b) of the FAA, (2) preemption of claims under § 1305(a)(1) of the FAA (commonly known as the Airline Deregulation Act), and (3) the rights of air carriers to exclude or refuse to accept passengers on international flights under the Tokyo Convention.

**FAA: Rights of Air Carriers to Exclude or Refuse to Accept Passengers**

Congress’s purpose in enacting the FAA was “to promote safety in aviation and thereby protect the lives of persons who travel on board aircraft.” To help accomplish that goal, 49 U.S.C. § 44902(b) of the FAA, known as “permissive refusal,” provides pilots with broad authority to remove passengers:

(b) Permissive refusal.—Subject to regulations of the Under Secretary, an air carrier, intrastate air carrier, or foreign air carrier my refuse to transport a passenger or property the carrier decides is, or might be, inimical to safety.

In other words, the pilot in command stands in the role of the air carrier and can decide whether to remove a passenger from a flight for safety reasons. This discretion is critical for a pilot in command, who is, according to the Code of Federal Regulations, “during flight time, in command of the aircraft and crew and is responsible for the safety of the passengers, crewmembers, cargo, and the airplane.”

**Implied preemption of state tort claims.** State tort claims relating to a passenger’s removal from an aircraft for safety reasons are preempted by § 44902(b). While the FAA does not contain an express preemption provision, § 44902 impliedly preempts state tort claims because it is a federal standard directly on point and constitutes pervasive federal regulatory control in that area. This was recently reaffirmed by the U.S. District Court for the Southern District of California in *Regis v. United Airlines, Inc.*, in which the court dismissed the plaintiff’s state tort causes of action, including false imprisonment, intentional infliction of emotional distress, negligence, and negligent infliction of emotional distress, allegedly arising from the plaintiff’s removal from an airplane due to a confrontation with a flight attendant. The court held that “[t]he FAA preempts all state law impinging upon the circumstances under which an air carrier may remove a passenger from a flight for safety reasons.”

“Arbitrary or capricious” standard. Given the deferential standard in § 44902(b), the majority of courts hold that the removal or refusal to transport a passenger cannot give rise to a claim for damages unless the carrier’s decision was “arbitrary or capricious.” The U.S. Court of Appeals for the First Circuit in *Cerqueira v. American Airlines, Inc.* clarified that “[t]he arbitrariness
or capriciousness standard here is not the same as reasonableness under a negligence standard.”

Some courts, including the First and Eleventh Circuits, have gone a step further and have interpreted § 44902 as an “affirmative grant” of permission to the air carrier, thus creating a presumption that the pilots’ decisions and actions were reasonable and placing the burden on the plaintiffs to show that § 44902 is inapplicable.11

To determine whether a pilot’s decision to remove a passenger was arbitrary or capricious, courts consider the facts and circumstances known by the pilot at the time she formed her opinion.12 This includes consideration of (1) the limited facts known by the pilot at the time, (2) the time constraints in making the decision, and (3) the general security climate surrounding the events.13 Because the pilot often has to make rapid decisions to ensure safety of the aircraft, the pilot does not have an obligation to make a thorough inquiry into the information received or the sources of that information or to conduct an independent investigation.14 This is true even if it is later determined that the crew exaggerated or made false statements to the pilot concerning the events leading up to the passenger’s removal.15

In Mercer v. Southwest Airlines Co., the Northern District of California clarified that a plaintiff cannot avoid the preemptive effect of § 44902 by alleging that the pilot’s belief that the plaintiff was injurious to the safety of the flight was factually inaccurate.16 The captain in Mercer ordered that the plaintiff be removed because he was believed to be a security threat based on representations made by the flight attendants. The plaintiff sued, alleging that § 44902(b) did not apply to his claims because the comment that he was a “security threat” was merely a pretext for racial discrimination.17 The court disagreed, holding that

\[
[p]laintiff misses the point. Defendant has it right that whether or not the captain was correct in his belief that Plaintiff posed a security threat, the fact that the safety of the flight was in question at the time Defendant acted is what is relevant to this analysis.18
\]

In Xiaoyun “Lucy” Lu v. AirTran Airways, Inc., the Eleventh Circuit held that conclusory statements by a plaintiff that her behavior did not threaten the safety of the flight were insufficient to prove that a pilot’s decision to remove the passenger was arbitrary or capricious.19 In that case, the plaintiff was removed from her flight based on the flight attendants’ representations that the plaintiff refused to comply with safety regulations and would not turn off her phone during takeoff. The plaintiff did not allege any “discriminatory animus for her removal from the flight,” instead insisting that she was not a threat to safety and that the flight attendants arbitrarily removed her from the aircraft.20 The court held that

\[
[j]udicial conclusory statements and bare assertions that [the plaintiff’s] behavior was not injurious to safety—despite her admitted failure to comply with safety regulations—do not plausibly support a claim that her removal from the flight was arbitrary or capricious.21
\]

In support of its holding, the court reaffirmed that

\[
[j]udge said there is no duty on the part of the captain to investigate recommendations by flight attendants for removal of a passenger, and the captain is entitled to take representations of flight attendants at face value.22
\]

A plaintiff may, however, prove that a decision by an air carrier to remove or refuse a passenger was arbitrary or capricious if she can show that no responsible decision maker would credit the information provided.23

For example, in Cordero v. Cia Mexicana de Aviacion, S.A., the Ninth Circuit reinstated the jury verdict in favor of the plaintiff, holding that there was ample evidence in the record from which the jury could conclude that the airline “acted unreasonably in excluding [the plaintiff] without even the most cursory inquiry into the complaint against him.”24 In that case, the plaintiff boarded a regularly scheduled nonstop flight from Los Angeles to Mexico City. In addition to a long delay on the ground, the pilot announced that they were going to make an unscheduled stop to pick up additional passengers along the way. At that point, a passenger near the plaintiff became loud and insulted the pilot, and the
The preemptive effect of § 44902(b) does not preempt claims arising from situations that occur in the airport terminal that are unrelated to any decision made by the pilot in command during boarding. For example, in the recent case Doe v. Delta Airlines, the U.S. District Court for the Southern District of New York held that § 44902 did not preempt the plaintiff’s state law tort claims arising from her alleged altercation with a gate agent and subsequent arrest for intoxication in the airport terminal. The court held that the plaintiff’s claims were not preempted because the altercation occurred in the terminal, the identities of the gate agent and person that reported the passenger to the police were unknown, and there was no indication that their actions were based on the pilot’s decision to deny the plaintiff boarding. The court held that, based on the available evidence, a jury could find that the plaintiff’s altercation in the airport terminal was entirely disconnected from the boarding process and the air carrier’s decision to deny boarding.

Preamption of Claims under the Airline Deregulation Act
Preemption under § 1305(a)(1) of the FAA, commonly known as the Airline Deregulation Act (ADA), provides additional protection that helps to ensure air carriers have discretion to remove potentially dangerous passengers without fear of legal consequences.

Before the ADA was enacted, air carriers’ routes, rates, and services were regulated under the FAA of 1958 by the Civil Aeronautics Board. Because the FAA contained a saving provision preserving preexisting statutory and common-law remedies, air carriers were also regulated by the states. In 1978, Congress enacted the ADA, the purpose of which was to eliminate federal regulations of rates, routes, and services to allow those aspects of air transportation to be set by market forces. The express preemption provision provides that states are prohibited from “enact[ing] or enforc[ing] a law, regulation, or other provision having the force and effect of law related to [an air carrier’s] price, route, or service.”

In Morales v. Trans World Airlines, Inc., the U.S. Supreme Court held that the phrase related to in the ADA expresses a “broad preemptive purpose” and that the ADA preempted the use of state consumer protection laws to regulate airline advertising, concluding that “relate[s]” means “has[s] a connection with, or reference to, airline rates, routes, or services.” The express preemption provision of the ADA has been interpreted to extend to claims arising out of an airline’s refusal to allow a passenger to board because those
claims concern the denial or inadequate provision of the airline’s “services.”

Preemption of state law claims related to a “service.” Courts consider three factors in determining whether the ADA preempts state law claims. First, the court must determine whether the activity in question implicates a service provided by the airline. Many courts, including the Fifth and Eleventh Circuits, have adopted the definition of service in the ADA specifically to include boarding procedures and baggage handling. Second, the court must determine whether the claim affects the airline service “directly or tenuously, remotely, or peripherally.” Finally, if the claim implicates an airline service and affects the service directly, the court must determine whether the underlying allegedly tortious conduct was reasonably necessary to the provision of the service. Analyzing the “reasonableness” inquiry of the third prong, the Southern District of New York in Rombom v. United Air Lines, Inc. held that

If the tortious act did not occur during the service in question or the tortious act did not further the provision of a service in a reasonable manner, the state tort claim should continue.

The court’s analysis in Rombom demonstrates that the preemption analysis under the ADA is claim specific and can result in different treatment for multiple claims arising from the same flight. In Rombom, the plaintiff’s tort claims centered around three distinct actions taken by the flight crew. She alleged that she was injured because (1) the flight crew acted in a “rude” and “unprofessional” manner when they told her to be quiet during the preflight safety briefing, (2) the captain decided to return to the gate, and (3) the flight crew arrested her out of spite. The court found that only the alleged spiteful arrest of the plaintiff was actionable.

The court held that the flight crew’s actions in asking the plaintiff to be quiet while they were giving safety instructions clearly implicated a service provided by the airplane (e.g., safety instructions) and was not outrageous or unreasonable even if they talked to the plaintiff in a rude manner. The court also held that the pilot’s decision about whether to take off or return to the gate was “unquestionably” a service provided by the airline because “such a decision determines whether the passengers will get to their destination.” The decision to return to the gate was not outrageous or unreasonable because the plaintiff did not have any evidence that the pilot’s decision was “motivated by any improper or malevolent scheme.” Rather, the evidence indicated that the pilot simply relied upon information received from the flight crew.

As to the plaintiff’s arrest after landing, the court found that such an action only implicates a service “if it is the only way to remove a passenger who refuses to disembark.” As the airline asserted that police were summoned because the plaintiff refused to disembark, the court agreed that this action implicated a service provided by the airline. However, the court found that the second prong of the test for preemption was not met, and therefore the plaintiff’s state tort claims could continue because

where the essence of the claim is that the air carrier abused its authority to provide a given service, the air carrier is not entitled to the protection of [the ADA].

The ADA does not shelter airlines from suits that do not allege violation of state-imposed obligation but instead only seek to recover for the airline’s breach of its own, self-imposed undertakings.

The court reasoned that even if the plaintiff’s claims directly implicated the service at issue, her claims would survive because, under the plaintiff’s version of the facts (that she voluntarily left the plane), arresting the plaintiff was not necessary to promote safety as “she ceased to pose any danger after the first flight attendant asked for quiet and she departed the plane quietly.”

Similarly, the U.S. Court of Appeals for the Fourth Circuit in Smith v. Comair, Inc. held that although tort claims can be preempted under the ADA if they relate to a price, route, or service of an air carrier, claims that stem[] from outrageous conduct on the part of an airline toward a passenger will not be preempted under the ADA if the conduct too tenuously relates or is unnecessary to an airline’s service.

The court noted that if an airline held a passenger without a safety or security justification, a claim arising
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from that action would not be preempted because it would not relate to any legitimate service provided by the airline.46

Contract-based claims not preempted. By its express terms, the ADA does not shelter airlines from suits that do not allege violation of state-imposed obligation but instead only seek to recover for the airline’s breach of its own, self-imposed undertakings. For example, in Chouest v. American Airlines, Inc., the court held that claims arising out of injuries sustained on a tour bus provided by the airline as part of a vacation package were not preempted by the ADA because the provision of ground transport-

than these rare circumstances, a pilot is protected in her ability to promptly make time-sensitive decisions to remove unruly or dangerous passengers without having to conduct an independent investigation. This allows the pilot to focus on the important job of assuring a safe flight for passengers and crew.

Tokyo Convention: Rights of Air Carriers on International Flights

The Convention on Offences and Certain Other Acts Committed on Board Aircraft, commonly referred to as the Tokyo Convention, limits the liability of the air carrier for intentional flights when a passenger, courts conduct a fact-specific analysis under both § 44902(b) and the ADA. Thus, a plaintiff may still have legal recourse in the exceptional situation where an air carrier acted outrageously and unreasonably or committed a tortious act unrelated to the services it provides. Other 

U.S. case interpretation. To date, Eid v. Alaska Airlines, Inc. is the only U.S. court case interpreting the Tokyo Convention.51 In that case, a group of nine plaintiffs alleged that they were forced to disembark an international flight based on a flight attendant’s uncorroborated allegation that their conduct had caused her to “lose control of the first-class cabin.”52

The Eid court declined to adopt the “arbitrary and capricious” standard for a pilot’s decision to restrain or remove passengers. Instead, the court applied an objective negligence standard of reasonableness, which it stated was consistent with the drafting history and plain lan-

On remand and after nine years of litigation, the Eid case resulted in a trial verdict in favor of the airline because the jury found that the pilots’ actions were reasonable.

tion by an airline is not a service as defined in the ADA.47

The cases interpreting the ADA reinforce the protections provided to air carriers and ensure that state law cannot undermine federal regulations. Because the permissive refusal provision in § 44902(b) and the preemption clause of the ADA both can be interpreted to preempt claims arising from an air carrier’s decision to exclude or refuse to accept a passenger on a domestic flight, defendants commonly move to dismiss under both theories.

While defendants have both statutes as potential sources of immunity for pilots’ and air carriers’ decisions to refuse or remove a passenger, courts conduct a fact-specific analysis under both § 44902(b) and the ADA. Thus, a plaintiff may still have legal recourse in the exceptional situation where an air carrier acted outrageously and unreasonably or committed a tortious act unrelated to the services it provides. Other 

gger’s claims arise from actions taken by the pilot or flight crew to preserve order and safety on board.48 Article 6 of the Tokyo Convention specifically authorizes the pilot in command of an international flight to “take reasonable measure including restraint” when he “has reasonable grounds to believe” that a passenger “committed, or is about to commit” a criminal offense or an act that jeopardizes the safety of the aircraft or “good discipline on board.”49 The Tokyo Convention further provides in Article 10 that, for actions taken in accordance with this Convention, neither the aircraft commander, any member of the crew, any passenger, the owner or operator of the aircraft, nor the person on whose behalf the flight was performed shall be held responsible in any proceeding on account of the treatment undergone by the person against whom the actions were taken.50
The dissent also noted that the majority misconstrued the holding by the Israeli court in the 2006 case Zirky v. Air Canada, which at the time was the only other published decision interpreting the Tokyo Convention’s reasonableness standard in Article 6. The dissent argued that the Zirky court’s interpretation of Article 6 was in line with the plain language of the Tokyo Convention and established a deferential standard similar to the arbitrary and capricious standard applied to decisions by pilots in command under the FAA. In support, the dissent noted that the Zirky court held that the proper standard for reasonableness conferred “extensive and wide authority” upon the captain and emphasized that “facts are not to be examined by hindsight . . . but at the time of the actual event.”

The Eid court’s interpretation is significantly different from the strong protections afforded under § 44902(b) and appears to require that pilots take the time to investigate the legitimacy of their crew’s representations about events occurring in the cabin despite their primary duty to safely pilot the aircraft.

Interestingly, despite the less deferential standard, on remand and after nine years of litigation, the Eid case resulted in a trial verdict in favor of the airline because the jury found that the pilots’ actions were reasonable.

Proposed amendments to the Tokyo Convention. After Eid, on April 4, 2014, the International Civil Aviation Organization adopted the Protocol to Amend the Convention on Offences and Certain Other Acts Committed on Board Aircraft at Montreal (Montreal Protocol 2014). In an attempt to clarify and unify courts’ interpretation of the “reasonable grounds” standard in Article 6 and in light of the less deferential standard announced in Eid, the United Arab Emirates, the International Air Transport Association, the International Federation of Air Line Pilots’ Associations, and the International Union of Aerospace Insurers submitted a working paper with a proposed amendment to Article 10 of the Tokyo Convention.

The working paper discussed the Eid decision and the dangers associated with its imposition of an objective reasonableness standard requiring the pilot to make some sort of evaluative enquiry about the behaviour of the passengers in question to determine whether reasonable grounds exist to use the power conferred by the [Tokyo] Convention.

The working paper emphasized that such an interpretation was problematic because protection from legal proceedings for the airline and its employees under Article 10 of the convention is critical if crews are to have the confidence to deal with any challenge to safety and security on board an aircraft.

In support of this view, the working paper also included an index discussing how the reasonable grounds standard in Article 6 has been or likely would be interpreted by different jurisdictions around the world. The working paper noted that “[t]he divergence in the case law on this issue clearly demonstrates the difficulty that courts have had in applying this key provision of the Convention.”

The working paper urged that Article 10 be amended to add an additional paragraph providing that

> [t]he aircraft commander will be accorded a high degree of deference in any review of actions taken by him or her in accordance with this Convention and any actions taken shall be assessed in light of the facts and circumstances actually known to him or her at the time that those actions were taken.

This standard would have ensured that interpretation of the Tokyo Convention was consistent with the deference provided to pilots on domestic flights under the FAA and that pilots and flight crew would know the limits of their discretion regardless of a flight’s destination.

Unfortunately, the recommendations in the working paper regarding the definition of reasonable grounds in Article 6 were not adopted in the Montreal Protocol 2014. Because the standard for reasonable grounds is undefined, it remains to be seen whether other courts will adopt the Eid court’s less deferential objective reasonableness in controversies arising under the Tokyo Convention.

Conclusion

Air travel in modern society can present significant safety and security concerns, and the pilot in command is required to make decisions swiftly based on information provided by the crew while at the same time continuing to safely plan the flight or pilot the aircraft. A pilot seeking to ensure a safe flight must be confident that she has the authority and discretion to remove a potentially dangerous passenger without fear that a court could second-guess her decision. Without that high level of discretion, § 44902 of the FAA, the ADA, and Articles 6 and 10 of the Tokyo Convention cannot have the critical, practical impact necessary to ensure that commercial air travel continues to be safe.

In the example of the May 2018 removal of the passenger from a Spirit Airlines flight, the pilot may have been presented with a
disruptive passenger who could threaten the safety of the aircraft and those on board. The discretion afforded to pilots under the FAA should allow them to remove potentially dangerous passengers with confidence and thus protect everyone on board. ■

Notes

3. Id. § 44902.
5. 49 U.S.C. § 44902(b).
8. Id.
10. Cerqueira, 520 F.3d at 14.
11. Id.; Xiaoyun “Lucy” Lu v. AirTran Airways, Inc., 631 F. App’x. 657, 661 (11th Cir. 2015).
12. Ruta v. Delta Airlines, 322 F. Supp. 2d 391, 397 (S.D.N.Y. 2004); Williams, 509 F.2d at 948.
13. Cerqueira, 520 F.3d at 14.
14. Id.
17. Id.
18. Id. (emphasis in original).
19. 631 F. App’x 657 (11th Cir. 2015).
20. Id. at 661.
21. Id. at 661–62.
22. Id. at 661.
23. Id.
24. Cordero v. Cia Mexicana de Aviacion, S.A., 681 F.2d 669, 672 (9th Cir. 1982).
26. Id.
27. Id.
29. Id.
31. Morales, 504 U.S. at 378.
32. 49 U.S.C. § 41713(b)(1) (1997); see also Northwest, 134 S. Ct. at 1429.
33. Morales, 504 U.S. at 384.
38. Id.
39. Id. at 223.
40. Id.
41. Id.
42. Id. at 224.
43. Id.
44. Id.
46. Id. at 259.
49. Id. art. 6.
50. Id. art. 10.
51. 621 F.3d 858 (9th Cir. 2010).
52. Id. at 869.
53. Id. at 866–67.
54. Id. at 869.
55. Id. at 869–70.
56. Id. at 885.
57. Civil File No. 1716-05 A (Haifa Magistrate Ct. 2006).
58. Eid, 621 F.3d at 882.
60. Protocol to Amend the Convention on Offences and Certain Other Acts Committed on Board Aircraft at Montreal, Apr. 4, 2014.
62. Id. ¶ 2.6.
63. Id. ¶ 2.10.
64. Id. ¶ 2.8.
65. Id. ¶ 2.12.

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