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Insurance 101-Insights for Young Lawyers: Evaluating First-Party Property Claims with Multiple Causes Under the Efficient Proximate Cause Doctrine

by Susan J. Field and Rina Carmel

First-party property claims can involve highly complex issues of causation. An understanding of the policy language, governing law, and facts of the claim (with the assistance of consultants, if appropriate) can assist both parties in an appropriate evaluation of coverage.

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Construction Defects as an "Occurrence": State Legislatures Weigh In

by Edwin L. Doernberger and Theresa A. Guerin

Construction industry policyholders and their commercial general liability carriers have long debated whether claims arising from defective construction constitute an "occurrence" triggering coverage. For thirty years, state courts have weighed in and have taken a multitude of different analytical approaches to the issue. Recently, four state legislatures have joined the discussion: Colorado, Arkansas, South Carolina and Hawaii. This article explores why the state legislatures chose to get involved and what they did to attempt to clarify coverage for construction professionals.

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Treatment of Insurance Proceeds and the Stafford Act's Public Assistance Grant Program

by Brent W. Huber and Susan Charles

This article examines the interplay between an insured's ability to recover from its insurer and its ability to obtain Public Assistance (PA) funding from the Federal Emergency Management Agency (FEMA) under the Robert T. Stafford Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, et seq. The article examines the statutory language and Congressional intent in promulgating the Act and concludes that, to the extent a PA recipient does not seek reimbursement of expenses already paid by or to be paid by insurance, the Stafford Act should allow recipients to determine how best to allocate insurance proceeds using reasonable commercial standards.

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One More Thing to Keep Directors and Officers Awake at Night: Dodd-Frank's Impact on D&O Insurance

by K. Alan Parry and Eric G. Barber

When Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, its intent was to "reshape the U.S. regulatory landscape," in an effort to restore confidence in a financial system still struggling to recover from the Great Recession. Among the many anticipated impacts of this far-reaching legislation is a likely increase in the exposure of corporate directors and officers to SEC enforcement actions and civil litigation as well. This article explores some of the potential D&O insurance coverage issues that may arise in the context of the Dodd-Frank reforms.

CBI for the Cloud

by Lon Berk

Business computing is being transformed by the cloud. Rather than maintaining and controlling their data and computation resources on site, with increasing regularity businesses are relying upon third-parties to provide and maintain these resources. Under this model, access to hardware, software and applications are provided to businesses through internet connections. A vendor, such as Amazon.com, permits the client to connect to a server farm providing the computation resources the client needs, as needed. Consequently, businesses can avoid the expense of acquiring and maintaining their own information technology and essentially rent time on the vendors' servers. Through virtualization, a programming technique that effectively permits a single server (or server group) to appear and operate as multiple servers, multiple businesses can operate their own computation systems on a single server system, obtaining the benefits of owning their own hardware but in fact acting as tenants on hardware belonging to another party.

The frequency of cloud computing is expected to increase as its advantages over individual ownership of a business' computation infrastructure are evident. As one commentator describes it:

The shift toward cloud computing is driven by many factors including ubiquity of access (all you need is a browser), ease of management (no need for user experience improvements as no configuration or back up is needed), and less investment (affordable

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Treatment of Insurance Proceeds and the Stafford Act's Public Assistance Grant Program

by Brent W. Huber and Susan Charles¹

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FEMA: THE INSURER OF LAST RESORT

Calendar year 2011 has again proven that disasters do not discriminate. Disaster can strike anyone, in any location and at any time. Just this year many have experienced devastating tornadoes, pounding hurricanes, raging fires and massive flooding. Of course, the events of 2011 are not surprising or unique. Our familiarity with natural and man-made disaster demonstrates that precautionary measures, including insurance, are appropriate and, in many cases, essential to a disaster victim's ability to rebuild.

But what if, despite diligent efforts to insure against disaster, a community experiences a catastrophe so extensive and so devastating that available insurance coverage is insufficient? In instances of such widespread, uninsured or underinsured losses, the federal government may be needed to step in and act as a sort of "insurer of last resort." The Robert T. Stafford Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, *et seq.* ("Stafford Act" or "Act"), authorizes financial and other forms of assistance to State and local governments and certain private nonprofit (PNP) organizations to support response, recovery and mitigation

efforts following Presidentially declared major disasters and emergencies.

The Federal Emergency Management Agency (FEMA) is responsible for implementing the Act's Public Assistance (PA) Grant Program. To be eligible for PA funding, disaster recovery work must be required as the result of a major disaster event, be located within a designated disaster area, and be the legal responsibility of an eligible applicant. Categories of disaster recovery work include: (a) emergency work (including debris removal and emergency protective measures); and (b) permanent work (such as repair of roads and bridges, water control facilities, buildings and equipment, utilities and parks). Very generally, costs that can be directly tied to the performance of eligible work are eligible for reimbursement. Significantly, however, eligible costs will be reduced by all applicable credits—including *insurance proceeds*.² In addition, the Stafford Act also expressly *excludes* recovery for certain types of losses and costs, including certain insurable losses such as business interruption.

[T]he "commercially reasonable" standard for approaching coverage questions is consistent with Congress' intent in enacting the Stafford Act and provides a more consistent and reliable standard than what FEMA has implemented to date

This article examines the interplay between insurance recoveries and policyholders' ability to obtain PA funding, and argues that FEMA should not discourage policyholders from entering into commercially reasonable settlements. One of the most important questions in evaluating the impact of insurance on PA funding is whether the available coverage would constitute a "duplication of benefits," something the Stafford Act and implementing regulations prohibit. More specifically, where an insured settles with its insurer for less than the insured's policy limits, can PA funding be used to make up the difference? Alternatively, where an insured's policy covers

both PA eligible (*e.g.*, property damage) and PA ineligible costs (*e.g.*, business interruption losses), how should the policy limits be allocated and what losses should be covered by PA funding?

Although these questions involve significant legal and public policy considerations, the statute and applicable regulations are virtually silent on the issue, and FEMA's position has been inconsistent at best. Although there is surprisingly little case law available to guide policyholders, the Ninth Circuit has adopted a "commercially reasonable" standard for evaluating a policyholder's actions with respect to available coverage.³ As discussed below, the "commercially reasonable" standard for approaching coverage questions is consistent with Congress' intent in enacting the Stafford Act and provides a more consistent and reliable standard than what FEMA has implemented to date.

THE INTERSECTION OF PUBLIC ASSISTANCE FROM FEMA AND INSURANCE

Several provisions of the Stafford Act address the impact of insurance coverage on PA funding. For example, Section 101(b)(4) of the Act requires that insurance coverage be subtracted from all applicable PA grants to avoid duplication of benefits.⁴ Further, if PA funds are obligated for work that subsequently is determined to be covered by insurance, FEMA must "de-obligate" those funds.⁵ Similarly, FEMA promulgated regulations outlining requirements for benefits received pursuant to an insurance policy. The regulations state that "actual and anticipated insurance recoveries shall be deducted from otherwise eligible costs. . . ."⁶ In addition, the regulations require notification to FEMA of any entitlement to insurance settlement or recovery and requires FEMA to "reduce the eligible costs by the amount of insurance proceeds" received.⁷

Following a disaster, a PA applicant also must demonstrate that it has obtained coverage for damaged insurable facilities (*e.g.*, buildings, equipment, contents and vehicles) as a condition of receiving PA funding.⁸ The applicant must document coverage in an insurance policy or binder and submit it to FEMA before project approval. The coverage must include buildings, equipment, contents and vehicles for the type of hazard that caused the damage⁹ and the applicant must maintain coverage on those facilities to be eligible for PA funding in future disasters.¹⁰ Except for projects where the total eligible damage is less than \$5,000, FEMA will not provide assistance for a facility in future disasters if the requirement to purchase and maintain insurance is not met.¹¹

FEMA also is required to reduce the amount of eligible PA funding for flood losses in a Special Flood Hazard Area (SFHA).¹² If an eligible and insurable facility damaged by flooding is located in a SFHA that has been identified for more than one year by the Administrator of FEMA, and the facility is not covered by flood insurance (or is underinsured) on the date of the flooding, FEMA will reduce PA funding by the maximum amount of insurance proceeds that would have been received had the building and contents been fully covered under a National Flood Insurance Program (NFIP) standard flood insurance policy.

DEVELOPING THE COMMERCIALLY REASONABLE STANDARD

In addition to the insurance-specific provisions outlined above, the duplication of benefits provision provides, in relevant part, that "no person, business concern or other entity will receive such assistance with respect to any part of such loss as to which he has received financial assistance under any other program or from insurance or any other source."¹³ The statute further states, "[a] person receiving Federal assistance for a major disaster or emergency shall be liable to the United States to the extent that such assistance duplicates benefits available to the person for the same purpose from another source. . . ."¹⁴

Section 5155 of the Act was not intended to be used to penalize disaster victims who have sought to recover aid from the Federal government for losses not covered by their insurance. Instead, the provision was promulgated merely to ensure that disaster victims act in a commercially reasonable manner by pursuing the maximum amount of money available from their insurers instead of simply relying on the federal government to bear the full costs of the disaster.¹⁵ This is precisely why the Stafford Act specifically provides that the "[r]eceipt of partial benefits for a major disaster or emergency shall not preclude provision of additional Federal assistance for any part of a loss or need for which benefits have not been provided."¹⁶ Indeed, the Stafford Act exists to spread "the cost of a major disaster from the citizens of the disaster-stricken community to the citizens of the entire country" and to supplement efforts and available resources to alleviate "the damage, loss, hardship or suffering caused by a disaster."¹⁷ To insist instead that a disaster victim "must take steps that it would not normally take regarding insurance coverage would be to demand that a disaster-stricken party be more vigilant in recovering dollars for the federal government than it would be in recovering dollars for itself."¹⁸

One of the few cases interpreting the duplication of benefits provision, *Hawaii v. FEMA*, 294 F.3d 1152 (9th Cir. 2002), examined FEMA's conclusion that Hawaii was liable to reimburse FEMA for coverage that was theoretically available to it under its insurance policies, notwithstanding its commercially reasonable decision to settle for less than policy limits. The State reached a settlement with its insurance companies after a hurricane devastated the area. FEMA was not satisfied with the amount of the settlement and maintained that the State could have received a greater amount under available insurance policies. Relying on Section 312(c) of the Stafford Act, FEMA asserted that a greater amount of coverage than the settlement amount was "available" to the State and, therefore, the State was obligated to reimburse FEMA for the amount in excess of the settlement that was available to the State. The court determined that the statutory meaning of "duplicative benefits available to the person" was ambiguous.¹⁹ The Ninth Circuit rejected FEMA's interpretation and concluded it was not reasonable, reasoning that the State did pursue and receive the insurance benefits available to it within the meaning of the Stafford Act because the State acted in a commercially reasonable manner when it settled with its insurers.²⁰

While FEMA has drafted policy documents purporting to interpret the potential for duplicative benefits associated with insurance coverage, FEMA's policy regarding the allocation of eligible and ineligible costs is far from clear.

APPLYING THE COMMERCIALY REASONABLE STANDARD

Neither the Stafford Act nor its implementing regulations address the allocation of an insurance policy that covers both PA eligible losses (e.g., property damage) and PA ineligible losses (e.g., business interruption losses). While FEMA has drafted policy documents purporting to interpret the potential for duplicative benefits associated with insurance coverage, FEMA's policy regarding the allocation of eligible and ineligible costs is far from clear. Indeed, FEMA has interpreted the duplicative benefits provisions of the Stafford Act and its own policy documents in an inconsistent fashion—making an insured's ability to request and recover PA uncertain.

FEMA's Disaster Assistance Policy, Policy No. 9525.3—Duplication of Benefits—Non-Government Funds, provides:

Disaster assistance will not be provided for damages covered by insurance. Disaster assistance provided by FEMA is intended to supplement assistance from other sources; therefore, insurance proceeds should be an applicant's first alternative for disaster assistance. For further guidance, refer to Disaster Assistance Policy Fact Sheet DAP9580.3, Insurance Considerations for Applicants.

Unfortunately, Disaster Assistance Policy Fact Sheet DAP 9580.3 only indirectly answers the question. That policy fact sheet includes the following "frequently asked question" and answer:

Where eligible and ineligible damage is insured in one policy, how will the insurance settlement proceeds be apportioned?

If the Applicant's insurance policy specifies the amount of coverage for each type of loss, the proceeds will be apportioned according to the policy limits.

If the insurer provides a Statement of Loss that specifies the amount of proceeds per type of loss, that will be used to determine the proceeds for eligible damage.

If the Applicant's insurance covers eligible and ineligible damage (for example, property damage and business interruption losses respectively) without specifying limits for each type of loss, the proceeds will be apportioned based on the ratio of the Applicant's eligible to ineligible damage. For example, if the Applicant's total losses are 60 percent property damage and 40 percent business interruption, then 60 percent of the insurance proceeds would be applied to offset the eligible damage, since business interruption losses are not eligible for reimbursement under the PA Program.

Unfortunately, FEMA's inconsistent application of these policy documents impacts their reliability and usefulness. For example, following Hurricane Rita the Memorial Hermann Baptist Hospital in Texas was not required to allocate its insurance proceeds proportionally among all insured risks based on documented damages.²¹ In that case the hospital had more than \$200 million in insurance coverage at the time of Hurricane Rita. However, the policy contained a problematic sublimit, a "Limited Named Storm Wind Coverage Endorsement," that limited coverage for damage from Hurricane Rita to \$25 million. The insurance policy covered FEMA eligible and ineligible damages (property damage and business interruption losses, respectively) without specifying limits for each type of loss. The hospital allocated \$22 million of the \$25 million in insurance recoveries to business interruption losses

and \$3 million to FEMA eligible repair work. As justification for the allocation, the hospital did not reference the overall proportion of eligible and ineligible losses. Rather, the hospital officials reasoned that, because disaster damage costs greatly exceeded insurance recoveries, insurance recoveries should be assigned to as much non-FEMA eligible damages as possible. According to the 2010 FEMA Memorandum, FEMA concurred with the hospital's decision to allocate its insurance proceeds in this manner. The 2010 FEMA Memorandum offers no additional information or guidance regarding FEMA's justification for its decision in the Memorial Hermann Baptist Hospital matter.

In contrast, in a case involving Columbus Regional Hospital ("CRH") in Southern Illinois, FEMA interpreted these same policy documents to require the hospital to reimburse FEMA for insurance proceeds it received, despite the fact that the hospital requested PA **only** for losses that would not be reimbursed by insurance.²² Not only is FEMA's treatment of CRH inequitable as compared to Hermann Memorial Hospital, but it is not "commercially reasonable." The Stafford Act provides that a recipient of disaster relief must reimburse the United States "to the extent that such assistance duplicates benefits available to the [recipient] for the same purpose from another source."²³ In *Hawaii v. FEMA*, the Ninth Circuit interpreted the term "available" to include benefits that could have been received from another source if the grantee had acted in a "commercially reasonable" manner.²⁴

The plain language of the Act only prohibits a person from receiving federal financial assistance when the damages sought have otherwise been paid for by a recovery from another source.²⁵ Section 5155(a) repeats the principle included in prior federal assistance statutes that the prohibition on duplicate benefits applies only to "such assistance with respect to which [the affected entity] has financial assistance under any other program."²⁶ Moreover, subsection b(3)²⁷ is entitled "Effect of partial benefits" and provides: "Receipt of partial benefits for a major disaster or emergency shall not preclude provision of additional Federal assistance for any part of the loss or need for which benefits have not been provided."

FEMA's interpretation is at odds with the long-standing concept of federal disaster legislation, in general, and the Stafford Act, in particular. As explained below, Congress intended that the Stafford Act provide financial assistance when the benefits actually received from non-federal sources fall short of the entire loss.²⁸

The plain language of the Act only prohibits a person from receiving federal financial assistance when the damages sought have otherwise been paid for by a recovery from another source

From at least 1966 through the Stafford Act amendments of 1988, the law was clear that partial compensation for a loss did not impede federal assistance for the remainder of the loss. Congress first addressed the topic of duplication of benefits briefly in the disaster relief act of 1966.²⁹ The topic of duplication of benefits reappeared in Section 208(b) of the disaster relief act of 1970.³⁰ Section 208(b) provided:

(b) The Director shall assure that no person, business concern, or other entity receives any Federal assistance for any part of a loss suffered as the result of a major disaster *if such person, concern, or entity received compensation from insurance or any other source for that part of such a loss. Partial compensation for a loss or a part of a loss resulting from a major disaster shall not preclude additional Federal assistance for any part of such a loss not compensated otherwise.*³¹

With the substitution of "President" for "Director," Section 208 of the 1970 act appeared as Section 315 of the Disaster Relief Act of 1974.³²

Congress passed the Stafford Act in 1988 to overhaul FEMA and its statutory authority because of the severe consequences of disasters and the need to use federal resources to assist in remedying them.³³ The express intent of Congress was to create a mechanism for the federal government to provide assistance to state and local government so that they can better "alleviate the suffering and damage which result" from disasters.³⁴ The legislative history of the 1988 Stafford Act amendment states that the duplicate benefits language in the Stafford Act was being modified to address two factors: 1) the fact that insurance companies were not paying claims in a timely manner; and 2) the fact that applicants were not filing claims for items that would have been covered by insurance.³⁵ In this regard, the 1988 Senate report provides as follows:

A recent study performed by FEMA indicates that in some cases, disaster assistance provided what should have been covered by an applicant's insurance. It appears that insurance companies are not paying claims in a timely manner, or that applicants are not filing claims for items which should have been covered. The new feature of section 312(a) gives FEMA . . . a

strong new mandate to provide disaster assistance only when insurance proceeds to which a person is entitled have been considered and the need for supplemental assistance remains.³⁶

The *Hawaii* court referenced this same legislative history, and concluded that “although the legislative history is far from decisive, it suggests that § 5155(c) was intended simply to ensure that disaster relief victims and insurers not take advantage of federal largess.”³⁷

Where FEMA eligible and ineligible losses are covered in the same policy, a disaster victim should be permitted to allocate its insurance recovery to mitigate otherwise unrecoverable losses

CONCLUSION

To the extent that a PA recipient does not seek reimbursement of expenses already paid by or to be paid

by insurance, the Stafford Act should allow recipients to determine how best to allocate insurance proceeds using reasonable commercial standards. The law should not force policyholders to litigate to a judgment in every case, especially in situations where commercially reasonable settlements are advisable. Where FEMA eligible and ineligible losses are covered in the same policy, a disaster victim should be permitted to allocate its insurance recovery to mitigate otherwise unrecoverable losses. In situations where FEMA ineligible losses exceed coverage limits, such an allocation would not result in PA applicants receiving a “windfall” or “duplicative recovery” from FEMA. Limiting a disaster victim’s ability to receive PA where that victim’s insurance coverage will not cover a loss, based on some hypothetical, fictitious allocation, would actually **increase** a PA applicant’s unreimbursed losses and harm the very communities the Stafford Act was intended to protect. This result is contrary to the letter and the spirit of the statute.

¹ This article does not necessarily represent the views of Ice Miller LLP or its clients, nor is anything contained herein intended to constitute legal advice. Mr. Huber and Ms. Charles are partners in Ice Miller LLP’s insurance recovery practice group, and can be reached at brent.huber@icemiller.com and susan.charles@icemiller.com.

² http://www.fema.gov/government/grant/pa/eligibility_costs.shtm.

³ See *State of Hawaii v. FEMA*, 294 F.3d 1152, 1165 (9th Cir. 2002).

⁴ 42 U.S.C. § 5121 (b)(4).

⁵ 42 U.S.C. § 5155 (c).

⁶ 44 C.F.R. § 206.250 (c).

⁷ 44 C.F.R. § 206.252 (c).

⁸ 42 U.S.C. § 5154.

⁹ 44 CFR § 206.252 (d).

¹⁰ 42 U.S.C. § 5154.

¹¹ 44 CFR § 206.252 (d).

¹² 42 U.S.C. § 5172 (d).

¹³ 42 U.S.C. § 5155 (a).

¹⁴ 42 U.S.C. § 5155(c).

¹⁵ *Hawaii*, 294 F.3d at 1164.

¹⁶ 42 U.S.C. § 5155 (b)(3).

¹⁷ *Hawaii*, 294 F.3d at 1160; House Report No. 100-517 (March 15, 1988).

¹⁸ *Hawaii*, 294 F.3d at 1164 (citing 42 U.S.C. § 5155 (c)).

¹⁹ *Hawaii*, 294 F.3d at 1162.

²⁰ *Hawaii*, 294 F.3d at 1165.

²¹ See June 7, 2010 Memorandum from Robert J. Lastrico, FEMA Western Regional Director, to Tony Russell, FEMA Region VI Administrator regarding “FEMA’s Practices for Evaluating Insurance Coverage for Disaster Damage and Determining Project Eligibility and Costs Report DS-10-08” (“2010 FEMA Memorandum”).

²² *Columbus Regional Hospital v. FEMA*, Cause No. 1:10-cv-1168-SEB-MJD, pending, S.D. Ind.

²³ See 42 U.S.C. § 5155 (c).

²⁴ See *Hawaii v. FEMA*, 294 F.3d 1152, 1161, 1165–66 (9th Cir. 2002) (holding that *Hawaii* was not liable to federal government for more than amount it actually received under insurance settlement, where settlement was commercially reasonable).

²⁵ See 42 U.S.C. § 5155; *Hawaii*, 294 F.3d at 1160.

²⁶ 42 U.S.C. § 5155(a).

²⁷ 42 U.S.C. § 5155(b).

²⁸ 42 U.S.C. § 5121 (b)(4).

- ²⁹ See, P.L. 89-769, 80 Stat. 1316 (89th Cong. 2d Sess.), reprinted in 1966 U.S.C.C.A.N. 1537, 1543.
³⁰ See (P.L. 91-606, 84 Stat. 1744 (91st Cong. 2d Sess.), reprinted in 1970 U.S.C.C.A.N. at 2039-46) (Addendum 3).
³¹ See (P.L. 91-606, 84 Stat. 1744 (91st Cong. 2d Sess.), reprinted in 1970 U.S.C.C.A.N. at 2039-46) (Addendum 3) (emphasis added).
³² See (P.L. 93-288, 88 Stat. 143 (93rd Cong., 2d Sess.), reprinted in 1974 U.S.C.C.A.N. at 160-184).
³³ 42 U.S.C. § 5121 (2006).
³⁴ 42 U.S.C. § 5121(b).
³⁵ See S. Rep. No. 100-524, at 13 (1988).
³⁶ See S. Rep. No. 100-524, at 13 (1988).
³⁷ *Hawaii*, 294 F.3d at 1163.

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