

Client Alert

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Lender Entitled to Insurance Recovery Under Property Policy Issued to Lender's Mortgagor

The US Court of Appeals for the First Circuit held in *Fidelity Co-operative Bank v. Nova Cas. Co.*, Nos. 12-1572, 12-2150 (1st Cir. Aug 7, 2013), that a bank assigned rights under a first-party insurance policy was entitled to recover for loss resulting from water intrusion following a torrential downpour. The First Circuit reversed summary judgment for the insurer, finding that the efficient proximate cause of the loss was the accumulation of "surface water" on the roof of the building, and that a "rain limitation" in the policy, which otherwise barred coverage for interior damage caused by rain in the absence of some covered physical loss to the building, did not apply.

BACKGROUND

Matthew and Sondra Knowles ("the Knowles") owned a hundred-year-old mixed-use building that they rented to tenants in Clinton, Massachusetts (the "building"). The building had a flat, rubber-covered roof, which had two skylights and a single drain at its center. The building was subject to a mortgage issued by Fidelity Co-operative Bank ("Fidelity") and was insured under an all-risk policy issued by Nova Casualty Company ("Nova").

A tropical storm dumped heavy rain on the building, which collected on the roof, overwhelming the drain and allowing water to accumulate around the two skylights. The skylights leaked, causing substantial damage to the interior of the building, rendering it unsafe. The town of Clinton subsequently directed that the building (which had been fully occupied) be closed and its tenants evacuated until the building was deemed safe by a structural engineer.

The policy included coverage for loss caused by "flood." "Flood" was defined as "a general and temporary condition of partial or complete inundation of normally dry land areas due to: the unusual or rapid accumulation or runoff of surface waters from any source." The Knowles submitted a claim to Nova for the water damage. Nova denied the claim on several grounds. First, Nova based its denial on the policy's "rain limitation," which excluded coverage for loss to "[t]he interior of the building caused by or resulting from rain, whether driven by wind or not, unless [t]he building first sustains damage by a Covered Cause of Loss to its roof or walls through which the rain enters." Nova relied on reports from two engineering experts, which stated that water entered the building "because of a backed-up roof drain and not through damage to the roof or walls." Thus, because there was no covered damage to the building that allowed the water to enter into it, the "rain limitation" applied to bar coverage.

Nova also based its denial on the policy's "faulty workmanship exclusion," which applied to damage resulting from "[f]aulty, inadequate or defective [d]esign, specifications, workmanship, repair, construction, renovation, remodeling, grading, compaction; materials used in repair, construction, renovation or remodeling; or maintenance of part or all of any property on or off your 'covered locations.'" Nova argued that the "drain strainer and the single 2.5-inch diameter roof drain were inadequate to handle the water deposited from the rain storm." As such, Nova contended that the damage was caused by faulty workmanship, which was excluded.

Following the loss and while the building was vacant, vandals entered the building and cut out most of the building's copper pipe. A separate claim was submitted to Nova for the theft. That claim was denied based on a "vacancy exclusion," which barred coverage for damage resulting from vandalism or theft to property left vacant for at least 60 days.

Unable to afford repairs to the building, and with their financial losses mounting due to their inability to allow tenants to return because of the town's closure order, the Knowles defaulted on their mortgage, with Fidelity taking title to the property. Fidelity also negotiated an assignment of the Knowles' rights under their policy with Nova.

Fidelity brought suit against Nova and both parties moved for summary judgment. The district court granted judgment in favor of Nova, holding that the rain limitation excluded the Knowles' initial loss because, when the water "pooled on the roof," it became "surface water which entered the building through the eroded metal and glass skylights." The court further held that, because the "water pooled due to a faulty or inadequate drain does not trump the surface water exclusion which bars coverage." *Fid. Coop. Bank v. Nova Cas. Co.*, 2012 U.S. Dist. LEXIS 51313, *13 (D.Mass. Apr. 11, 2012). The district court also found the faulty workmanship exclusion inapplicable to the Knowles' loss, finding that the purpose of that exclusion is to guard against the insurer's becoming a guarantor of a construction project, a situation not present in the case at hand.

Finally, the district court ruled that the policy's vacancy exclusion applied to bar coverage for all loss associated with the subsequent vandalism and theft of copper piping. The court rejected the Knowles' argument that Nova was estopped from relying on the exclusion because it wrongfully denied the Knowles' water damage claim.

APPEAL & HOLDING

On appeal, Fidelity sought to distinguish between damage "caused by rain" and damage caused by "surface water," arguing that the rain limitation narrowly applied only where rainfall was the "efficient proximate cause" of damage and that, here, the damage resulted from an accumulation of "surface water" on the roof. Fidelity further argued that Nova's own structural engineers found the building's damage was not "caused by rain," but by a "blocked or inadequate roof drain," which allowed the "surface water" to accumulate.

Fidelity cited two decisions from Massachusetts' highest court, issued after the entry of summary judgment. See *Boazova v. Safety Ins. Co.*, 462 Mass. 346 (2012) ("surface water," while "derived from falling rain," is not the same as "rain" within the meaning of "rain limitations" under all-risk insurance policies); *Surabian Realty Co. v. NGM Ins. Co.*, 462 Mass. 715 (2012) (same). In both of those cases, Massachusetts' highest court found that rainwater accumulating on an artificial surface was, indeed, "surface water." The First Circuit rejected Nova's argument that the rain limitation failed to support a finding that rain becomes "surface water" when it "touches some surface, ground or not."

The court then looked to the efficient proximate cause of the loss: the "cause that sets in motion a train of events which brings about a result without the intervention of any force started and working actively from a new and independent source is the direct and proximate cause."

Applying that test, the First Circuit observed that "Nova's own experts determined that the blocked or inadequate roof drain caused the water to accumulate," so that the water "backed up on the roof and ponded," and the roof "flooded." Thus, "when the blocked or inadequate drain was overwhelmed by the severe rainstorm, it set in motion a 'train of events' lacking the intervention of any forces or activation of a new source to cause the interior water damage," and the drain failure — not the tropical storm — was the efficient proximate cause of the water damage. The rain limitation, therefore, did not apply.

The First Circuit also found that the faulty workmanship exclusion was inapplicable, since the Knowles neither built, nor repaired, the drain that failed to take in all the water it needed to on the night of the tropical storm.

IMPLICATIONS

Fidelity Co-operative Bank illustrates that coverage is available for so-called “water losses” despite recent attempts by insurers to argue for broad interpretations of their exclusions. The decision also carries particular import for banks and other financial institutions because it illustrates the potential value that may remain under defaulting mortgagors’ insurance policies. In such cases, lenders and successors should promptly evaluate all known insurance coverage to determine whether any pre-default losses may be subject to insurance recovery.

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