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Arizona District Court Rules on the Scope of Cyber Liability Coverage for Credit Card Payment Association Fees

by Anne Juntunen

Until now, courts addressing the availability of coverage for data breach losses have contended with traditional liability policies. This is finally changing as courts are beginning to adjudicate claims for coverage under standalone cyber policies designed with cyber breaches in mind.

In what appears to be the first substantive decision on indemnity under a cyber policy, the U.S. District Court for the District of Arizona in *P.F. Chang's China Bistro, Inc. v. Federal Insurance Company*,¹ granted summary judgment to Federal Insurance Company (a division of Chubb) on a claim for damages resulting from a data breach. The insured sought coverage for a credit card association assessment issued to a third party payment processor and passed on to the insured. Senior District Judge Stephen McNamee held that the assessment was not covered under the cyber liability policy by reason of the contractual liability exclusions.

The Data Breach

The insured, restaurant chain P.F. Chang's, sought coverage under its CyberSecurity by ChubbSM policy after discovering that hackers had posted 60,000 customers' credit and debit card information online. When

this became public, the insured's customers launched several class actions against P.F. Chang's for failing to adequately protect their information, alleging that they were at an increased risk for identity theft as a result. The insured also received a demand from its credit card payment processor, Bank of America Merchant Services ("BAMS"), to reimburse it for a MasterCard "assessment" for costs associated with fraudulent charges on the stolen card numbers.

This case is particularly noteworthy because P.F. Chang's made claims under both its Chubb cyber liability policy and its Travelers CGL policy. Travelers denied coverage and ultimately brought a declaratory action seeking a determination that it had no duty to defend the class actions because (1) the lawsuits did not trigger coverage and (2) even if they did, they would trigger the exclusions for violations of consumer financial protection laws.² Chubb, however, agreed to defend the class actions and pay the forensic investigation costs, but it declined coverage for the MasterCard assessment. It was the MasterCard assessment that was at issue in the *P.F. Chang's v. Federal* decision.

The MasterCard Assessment

The MasterCard assessment consisted of three charges totaling approximately \$1.9 million:

1. approximately \$1.7 million in fraudulent charges made on credit cards that had been compromised in the breach (known as the "Fraud Recovery"),
2. approximately \$163,000 in costs associated with notifying cardholders of the compromise and issuing new cards (known as an "Operational Reimbursement"), and
3. a \$50,000 "Case Management Fee" in respect of MasterCard's costs of determining the losses and administering compensation.

BAMS submitted the assessment to P.F. Chang's for reimbursement under P.F. Chang's merchant services agreement. The agreement provided that BAMS would supply credit card processing services to P.F. Chang's restaurants, and included provisions stating that P.F. Chang's would indemnify BAMS for fees imposed by

credit card associations pursuant to their respective card rules.

The Policy

As in many cyber policies, the Chubb policy at issue in *P.F. Chang's* offered coverage for both third-party loss and first-party damages. The liability coverage was found in Insuring Clause A, which provided coverage for loss “on account of any Claim first made against [the] Insured . . . for Injury.” The policy defined “Injury” to include, in relevant part, “Privacy Injury”: an “injury sustained or allegedly sustained by a Person because of actual or potential unauthorized access to such Person’s Record”. The relevant definition of “Record” pertained to non-public information in the care, custody or control of an “Insured”.

The policy’s first-party coverage included coverage for, among other things, “Privacy Notification Expenses” (defined as the “reasonable and necessary costs” of notifying victims) and “Extra Expenses” (defined as “reasonable expenses” incurred to continue operations at a normal level).

The Analysis

At the heart of the coverage dispute was the Fraud Recovery fee. P.F. Chang’s argued that this should be covered under Insuring Clause A because it represented an amount that the insured was legally obligated to pay as a result of BAMS’ demand for damages for a “Privacy Injury”. The card issuers had suffered the “Privacy Injury” because it was the card issuers’ information that was compromised in the breach; the insured argued that this injury had simply been passed on through BAMS, the claimant against P.F. Chang’s.

Chubb argued that the Fraud Recovery fee could not qualify as a “Privacy Injury” because a “Privacy Injury” must be caused by unauthorized access to *the claimant’s* information. In this case, the compromised information

belonged to the card issuers, not BAMS, so there was no “Claim” for “Privacy Injury”.

The Court agreed with the more restrictive interpretation advocated by Chubb, reasoning that the wording of the insuring clause meant that only the company whose information has been compromised or potentially compromised can suffer a “Privacy Injury”. Thus BAMS’ claim for reimbursement, which sought to recover for MasterCard’s claims in respect of injuries suffered by someone else (the card issuers), could not trigger coverage.

Regarding the other two components of the assessment—the Operational Reimbursement fee and the Case Management Fee—the Court agreed with P.F. Chang’s on the applicability of the insuring clauses. The Court determined that the Operational Reimbursement fee was incurred to compensate issuers for their costs in notifying cardholders of the security compromise and therefore qualified as a “Privacy Notification Expense”. The Court went on to hold that the Case Management Fee might qualify as an “Extra Expense”, as failing to pay this would mean P.F. Chang’s could no longer accept credit card payments from its customers. As a result, the policy’s coverage was either triggered (in the case of the Operational Reimbursement fee) or potentially triggered (in the case of the Case Management Fee).

In the end, however, the Court’s decision came down to the application of the policy’s exclusions. The Court held that no coverage was available for any component of the MasterCard assessment due to the policy’s exclusions for contractual liability, which barred coverage for contractual obligations assumed by the insured.

Noting the dearth of authority interpreting cyber insurance policies, the court looked to the CGL case law,

explaining that “the fundamental principles are the same.”³ The Court concluded that P.F. Chang’s had paid BAMS because of the indemnity obligations contained in its merchant services agreement. P.F. Chang’s had not pointed to evidence that it would have been liable to BAMS even in the absence of a contractual assumption of liability, so no exception to the exclusion would apply under the circumstances.

The Court also rejected P.F. Chang’s argument that it had an expectation of coverage. The insured argued that whatever its policy might say, it had a reasonable expectation that its cyber policy would cover payment card assessments, given the likelihood of such assessments following a data breach. The Court rejected that argument, saying there was no evidence that the insured had actually formed an expectation at the time of underwriting that it was purchasing a policy that would cover credit card association assessments.

Lessons

The decision in *P.F. Chang’s* is noteworthy in that it not only provides a first glimpse into how courts are likely to approach cyber coverage disputes, but also addresses the issue of cyber coverage for payment card assessments, which make up a significant portion of potential losses flowing from a data breach.

Of particular interest is the Court’s application of the contractual liability exclusion, which highlights a dilemma faced by insureds in payment card assessment cases. Typically contractual liability exclusions are triggered when a contract forms the sole basis for the liability in question. In the case of P.F. Chang’s, it is certainly conceivable that the restaurant chain would have been liable for damages flowing from its failure to adequately protect credit card information, and that these damages would include reimbursement

of fraudulent charges and the cost of issuing new replacement cards. But where the insured pays fees in response to a demand under a contractual indemnity clause, the insured must present at least some evidence that it would have been liable even in the absence of the agreement.

In its Statement of Facts, P.F. Chang's pointed out that it had been the target of *allegations* of negligence, but it did not go so far as to argue that it fell short of a duty of care. The lack of evidence on this point may have affected the outcome; in explaining its holding that the exclusion applied, the Court commented, "*Chang's does not direct the Court's attention to any evidence in the record indicating that Chang's would have been liable for these Assessments absent its agreement with BAMS*".

The insured may have chosen not to assert its own negligence in order to avoid the application of the exclusion – a choice many insureds might make in light of pending customer claims against them and the unattractiveness of such a posture. If, in another case, the insured chose to assert its own negligence to avoid the application of the contractual liability exclusion, this would create a risk that the assertion would be used against both insured and insurer in a class action seeking to establish the insured's liability.

Conclusion

P.F. Chang's may be the first cyber coverage decision addressing coverage for payment card assessments, but it will not be the last. The quantum of such assessments, combined with the complicated structure of the payment card industry, creates fertile ground

for questions about the scope of cyber coverage for credit card-related damages. Questions of coverage are complicated by the nature of the contractual relationships that undergird the payment card industry, which distribute losses from the card issuer to the payment card association, payment processor and, eventually, the merchant. Because of this the party that initially suffers the brunt of the loss may not be the same party that ultimately claims against the insured for those damages. 🌟

Endnotes

¹ *P.F. Chang's China Bistro, Inc. v. Fed. Ins. Co.*, No. CV-15-01322-PHX-SMM, 2016 WL 3055111, at *1 (D. Ariz. May 31, 2016).

² Travelers' declaratory coverage action was stayed after the underlying lawsuits against P.F. Chang's were dismissed for lack of standing. This decision was overturned on appeal by the Seventh Circuit, which held that the increased risk of fraudulent charges and identity theft, where the

plaintiffs' data had already been stolen, was sufficient to give the cardholders standing to sue. The customer class action was therefore revived. *Lewert v. P.F. Chang's China Bistro, Inc.*, No. 14-3700, slip op. (7th Cir. April 14, 2016).

³ *P.F. Chang's*, 2016 WL 3055111, at *8.