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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Travelers, Tilton Top Insurance Appeals To Watch This Fall

By **Jeff Sistrunk**

Law360 (August 31, 2018, 11:29 AM EDT) -- Federal appeals courts are set to hear arguments in several potentially precedent-setting cases in the coming months, including Travelers' challenge of a ruling that it must pay a private equity firm $87 million to defend lawsuits involving a portfolio company's products and a bid by Lynn Tilton's investment firm for excess coverage of a U.S. Securities and Exchange Commission probe.

Here, Law360 breaks down four key oral arguments insurance attorneys should watch this fall.

Charter Oak Fire Insurance Co. v. American Capital Ltd.

On Sept. 28, Travelers Property Casualty Co. will aim to convince the Fourth Circuit to upend a ruling that it must pay $87 million to private equity firm American Capital Ltd. and one of its portfolio companies to fund their defense of scores of suits over tainted blood thinner, in a case that has seized insurance attorneys' attention due to the trial court's policyholder-friendly interpretation of a common policy term.

Beginning in 2008, American Capital and its portfolio company Scientific Protein Laboratories LLC have been hit with more than 1,000 suits over deaths and injuries allegedly traced to an adulterated batch of the blood thinner drug heparin, which Scientific Protein manufactured in part through a joint venture with a Chinese subsidiary.

Following a four-week bench trial, Senior U.S. District Judge Deborah K. Chasanow ruled in August 2017 that Travelers breached its duty to defend when it refused to pay American Capital and Scientific Protein's legal fees. The primary and excess liability policies issued by Travelers only named American Capital as an insured, but Judge Chasanow said the policies also covered the portfolio company, thanks to language providing coverage for all companies in which the named insured holds a "majority interest."

The district judge's ruling was the first in the country to hold that the "majority interest" language — which is "widely used" by various insurers, according to the opinion — extends coverage held by a private equity firm to its portfolio companies. That phrase can have many different meanings in different contexts, noted Hunton Andrews Kurth LLP partner Syed Ahmad, who represents policyholders.

“That is why the court found the language ambiguous, which can open up a Pandora’s box about what was intended when the policy was issued,” Ahmad said. “Importantly, the district court construed the ambiguity against Travelers because it drafted the language found [to be] ambiguous. Insurers face a risk of similar rulings in other cases involving the same language.”

Travelers has argued on appeal that it never intended its policies to apply to American Capital’s portfolio companies, and that in any case coverage is precluded by an exclusion that bars coverage for claims pertaining to joint ventures. A decision affirming the lower court's ruling would give the private equity firm an “$87 million windfall for insurance coverage that neither party intended,” the insurer contended in its appellate briefs.

American Capital, of course, has countered that the trial court correctly held Travelers liable for breaching its duty to defend, and has also asked the appellate court to go a step further than Judge Chasanow and tack on bad-faith penalties.

Travelers’ bid to unseat Judge Chasanow’s ruling drew the support of two prominent insurance trade groups, the American Insurance Association and the Complex Insurance Claims Litigation Association. In a joint amicus brief, the associations said the district court's decision was disturbing because the joint venture exclusion clearly applies to defeat coverage for both American Capital and Scientific Protein.

“While an insurer must defend an insured against covered claims even if the facts alleged are false, an insurer has no duty to defend a noninsured against any claims,” the groups’ attorney, Crowell & Moring LLP partner Laura Foggan, wrote in the brief. “This is fundamental to the insurance agreement. Imposing a duty to defend a noninsured on the insurer would fundamentally alter the obligations assumed under the insurance contract.”

American Capital is represented by John W. Schryber, Kim M. Watterson and Andrew M. Weiner of Reed Smith LLP.

Travelers and Charter Oak are represented by Theodore J. Boutrous, Jr. Blaine H. Evanson Jessica R. Culpepper and Rebekah Perry Ricketts of Gibson Dunn & Crutcher LLP, Kevin O'Connor of Hermes Netburn O'Connor & Spearing PC, and Andrew Jay Graham and Steven M. Klepper of Kramon & Graham PA.

The case is Charter Oak Fire Insurance Co. et al. v. American Capital Ltd. et al., case number 17-2015, in the U.S. Court of Appeals for the Fourth Circuit.

Madelaine Chocolate Co. v. Great Northern Insurance Co.

Nearly five years after Superstorm Sandy thrashed the East Coast, the Second Circuit will hear arguments on Oct. 4 over whether a windstorm endorsement in a property insurance policy supersedes an exclusion for flood losses — an issue that is common in coverage disputes arising from the storm.

Policyholder Madelaine Chocolate Novelties Inc. is seeking to reverse U.S. District Judge Raymond J. Dearie’s September 2016 ruling that Sandy's storm surge was encompassed by the flood exclusion in its "all-risk" policy with Chubb Ltd. unit Great Northern Insurance Co., thereby foreclosing its request for more than $49 million in coverage for property damage and business interruption losses.

In its appellate briefs, Madelaine has contended that Judge Dearie's decision was erroneous because the limitations imposed by the flood exclusion were superseded by an endorsement added onto the policy that enhanced coverage for losses attributed to windstorms.

"Because it is a weather event whose 'primary motive force' is wind, storm surge falls plainly within the policy's definition of the 'covered peril' of 'windstorm,'" Madelaine argued.

Great Northern, however, fired back that nothing in the windstorm endorsement overrides the plain language of the flood exclusion.

The Second Circuit's decision could prove to be influential as coverage litigation stemming from Sandy continues to wind down. According to attorneys, an appellate decision upholding Judge Dearie's ruling could shut down another avenue for policyholders to seek further recovery for Sandy-related losses.

"The policyholder paid for an all-risk policy, so unless a cause of loss is excluded within the terms of the policy itself, it will be covered," said Clark & Fox partner Michael Savett, who represents insurers. "There is really no dispute that, if a loss was caused by a windstorm alone, there would be coverage. Here, because the proximate cause of this loss was flood — and there is no coverage for flood — it seems to be a stretch for the policyholder to argue that somehow this endorsement creates a conflict with the clear and unambiguous language of the exclusion."

But Ahmad said that coverage grants, like the windstorm endorsement, are typically "entitled to a broad interpretation in favor of coverage," which may support a reversal of the lower court's decision. In any event, he added, the outcome of each Sandy insurance case will depend on the specific policy language at issue.

"We will have to wait and see how expansive the court's ultimate rationale is, but the decision will nevertheless be closely watched given the few precedents on point," Ahmad said. "But I would caution against predicting the significance of the Second Circuit's ruling for other similar claims. Like in any coverage dispute, the specific policy language matters. It matters a great deal."

Madelaine is represented by Edward M. Joyce, Jason B. Lissy and James M. Gross of Jones Day.

Great Northern is represented by Jonathan Hacker and Jennifer B. Sokoler of O'Melveny & Myers LLP, and Melissa F. Brill and Thomas McKay III of Cozen O'Connor.

The case is Madelaine Chocolate Novelties Inc. d/b/a The Madelaine Chocolate Co. v. Great Northern Insurance Co., case number 17-3396, in the U.S. Court of Appeals for the Second Circuit.

Patriarch Partners LLC v. Axis Insurance Co.

On Oct. 15, the Second Circuit will return to the insurance realm when it hears arguments in investment firm Patriarch Partners LLC's appeal of a lower court's ruling that it cannot access excess coverage from Axis Insurance Co. to help defray the costs of a U.S. Securities and Exchange Commission probe and enforcement action. The case will give the influential appellate court the chance to weigh in on the heavily litigated issue of when a government probe triggers coverage under a directors and officers policy.

The SEC had claimed Patriarch and its chief executive, Lynn Tilton, misled investors about the performance of the firm's so-called Zohar funds by improperly categorizing loans that missed interest payments as current rather than defaulted, allowing for the collection of fees and payments that the agency argued should have been used to pay down the notes instead. An administrative law judge ultimately entered an order in September 2017 dismissing the agency's action in its entirety, court records show.

Patriarch incurred more than $25 million in legal bills defending against the SEC proceedings, and three of its directors and officers insurers agreed to pay $20 million of that sum, according to court documents. Axis, however, refused to pay under its $5 million excess D&O policy, asserting that the SEC probe was already in progress by the time it issued the policy in July 2011, thereby triggering an exclusion for "prior and pending" litigation.

Patriarch argued the SEC investigation did not formally get underway until the firm was served with its first subpoena in February 2012, but U.S. District Judge Valerie Caproni found in September 2017 that the probe began when the SEC issued its first nonpublic order of investigation in early June 2011, before the Axis policy went into effect.

On appeal, Patriarch has contended that the district court erred because neither the nonpublic order of investigation nor other informal acts by the SEC constituted a claim under the Axis policy. But Axis has said that Patriarch is grasping at straws, especially since the investment firm was well aware of the SEC probe before the excess policy was issued but chose not to disclose that fact on its policy application.

According to attorneys, the case presents a unique twist on well-trodden legal territory. In most similar cases, policyholders have argued that early phases of an SEC investigation constitute claims in order to maximize coverage across multiple policy periods. Patriarch, on the other hand, has taken the position that those early acts are not claims, so as to avoid the application of a policy exclusion.

The outcome of the case may turn on whether or not the Second Circuit finds that the SEC’s initial order of investigation included allegations of a “wrongful act” by Patriarch or its insured executives, as required to trigger coverage, said Dentons partner Jack Vales, who represents insurers.

Judge Caproni has said yes, pointing to language in the order stating the SEC had information "tend[ing] to show" that Patriarch may have defrauded its clients in "possible violation” of securities laws. As Patriarch sees it, though, the order indicates only that the agency was "investigating whether a basis existed for alleging a wrongful act."

“I think it is a close call,” said Vales.

Patriarch is represented by Finley T. Harckham and Luma Al-Shibib of Anderson Kill PC.

Axis is represented by John R. Gerstein and Gabriela Richeimer of Clyde & Co. US LP.

The case is Patriarch Partners LLC v. Axis Insurance Co., case number 17-3022, in the U.S. Court of Appeals for the Second Circuit.

Principle Solutions Group v. Ironshore Indemnity Co.

In another closely watched case, the Eleventh Circuit is slated to hear arguments in November in Ironshore Indemnity Co.'s challenge of a lower court's ruling that it must cover information technology company Principle Solutions Group's $1.7 million loss to an email-based "social engineering" theft scheme.

The dispute dates back to July 2015, when a Principle employee received an email purportedly from her boss that indicated the company was making an acquisition and that she should work with an attorney named Mark Leach to "ensure that the wire goes out today," according to court papers. Principle has denied that the executive sent the message.

The Principle employee had a phone conversation with "Mark Leach" — who was actually a fraudster — and received wire instructions to be provided to the company's bank, according to court documents. The resultant transfer cost Principle $1.72 million and the thief was never caught, court records show.

After Ironshore declined coverage for the loss, Principle filed suit in Georgia federal court. In an August 2016 decision, U.S. District Judge Richard W. Story granted summary judgment to Principle, finding the language of the crime policy's "computer and funds transfer fraud" provision is ambiguous and must therefore be interpreted in Principle's favor.

The fact that there were multiple steps between the initial email and the transfer does not free Ironshore from its coverage obligations, the judge found.

"If some employee interaction between the fraud and the loss was sufficient to allow [Ironshore] to be relieved from paying under the provision at issue, the provision would be rendered 'almost pointless' and would result in illusory coverage," Judge Story wrote.

Ironshore has told the Eleventh Circuit that Judge Story's holding was faulty for multiple reasons. The insurer contended in an appellate brief that the judge utterly failed to apply the policy's specific definition of a fraudulent instruction, and asserted that coverage doesn't apply because the initial email to the Principle employee didn't directly result in the wire transfer.

Principle, however, argued in an answer brief that the district judge properly concluded that Ironshore's stance would effectively erase the policy's coverage.

While insurers prevailed in a chain of similar cases between 2015 and 2017, policyholders got a boost in July when both the Second and Sixth circuits ruled that crime policies afford coverage for social engineering scams. Principle took note, submitting both decisions to the Eleventh Circuit as supplemental authorities supporting an affirmance of Judge Story's ruling.

Oral arguments have been scheduled for the week of Nov. 5 but a specific day has not yet been set.

Ironshore is represented by Philip W. Savrin and William H. Buechner Jr. of Freeman Mathis & Gary LLP.

Principle is represented by Scott N. Godes and James J. Leonard of Barnes & Thornburg LLP.

The case is Principle Solutions Group LLC v. Ironshore Indemnity Inc., case number 17-11703, in the U.S. Court of Appeals for the Eleventh Circuit.

--Editing by Pamela Wilkinson and Rebecca Flanagan.