Client Alert

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Maryland District Court Holds Travelers Liable for Over $62 Million in Defense Costs for Private Equity Company and Its Portfolio Company in Heparin Litigation

Earlier this month, the United States District Court for the District of Maryland held, after a four-week bench trial, that Travelers breached its duty to defend by refusing to pay defense costs to its named insured, American Capital Ltd. (American Capital), and its majority-owned portfolio company, Scientific Protein Laboratories LLC (SPL), in connection with more than 1,000 underlying cases arising from allegedly contaminated heparin. The case is *The Charter Oak Fire Company et al. v. American Capital Ltd., et al.*, Case No. 8:09-cv-00100 (D. Md Aug. 3, 2017).

Background

American Capital, a publicly traded private equity firm, was the named insured under six insurance policies issued by two Travelers' subsidiaries: three primary commercial general liability (CGL) policies and three excess policies issued from 2006 to 2009. American Capital oversaw its portfolio companies through its wholly owned domestic consolidated operating subsidiary, American Capital Financial Services. In August 2006, American Capital formed and acquired an interest in SPL Acquisition Corp., which acquired SPL Holdings, LLC, which wholly owned SPL—a manufacturer and distributor of pharmaceutical ingredients. SPL was thus one of American Capital's portfolio companies.

The coverage dispute arose out of multidistrict litigation related to allegedly contaminated heparin, a blood thinning medication. SPL manufactured heparin sodium, USP, which was sold to pharmaceutical companies. Some, but not all, of the heparin that SPL provided to these companies was sourced from China. A subsidiary of SPL held rights to a Chinese entity, Changzhou SPL Co., Ltd., an entity created pursuant to a joint venture agreement between Changzhou Techpool Pharmaceutical Co., Ltd., a Chinese company, and a predecessor of SPL. After reports of severe patient reactions to heparin, including death, SPL and the pharmaceutical company recalled all the heparin products between January and March 2008. Lawsuits were filed beginning March 2008. Five hundred and seventy-four of these lawsuits were filed against American Capital, SPL or the pharmaceutical company Baxter in federal court and transferred to multidistrict litigation. Four hundred and ninety-one lawsuits were filed in state courts, most of which were consolidated. American Capital or SPL were named in almost every lawsuit, but many of the complaints did not mention the joint venture.

American Capital provided timely notice of the lawsuits on August 20, 2008, and Travelers investigated under a full reservation of rights. On January 16, 2009, the Travelers entities denied coverage for the heparin lawsuits. The insurers also initiated a declaratory action on that same date. At the time of trial, three of the insurers' counts remained: rescission of the policies against American Capital; reformation due to mutual mistake against American Capital; and a declaratory action on the duty to defend or indemnify. The insureds' counterclaims consisted of 14 counts, including that the rescissions were without legal basis, breach of contract for failure to defend, a statutory tort claim for lack of good faith and a common law tort claim for promissory fraud.

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In analyzing Travelers' duty to defend, the court reiterated hornbook law on the duty to defend: the complaint is covered if there is even a potential for coverage under the policy. Thus, even if the complaint fails to allege facts that clearly bring the claim within coverage, the insurer must defend so long as there is the potential that the claim would be covered under the policy.

Against this legal framework, the court explained its earlier summary judgment ruling, striking down the insurer's argument that the policy's joint venture exclusion applied to defeat the duty to defend. That exclusion stated that "no person or organization is an insured with respect to the conduct of any current or past partnership, joint venture or limited liability company that is not shown as a Named Insured in the Declarations." The insurers argued that the exclusion applied if the contaminated heparin originated with the Changzhou joint venture. The court rejected that argument, holding that regardless of whether the claims against American Capital concerned a joint venture not named in the declarations, whether the heparin originated with the joint venture—an unresolved question of fact —necessarily precluded summary judgment. Accordingly, the joint venture exclusion did not extinguish the insurers' duty to defend.[1]

The court also found rescission would not be appropriate. Although American Capital's broker answered "no" to a question on the policy application whether the applicant has "any subsidiaries," the court found the misrepresentation to be immaterial because the underwriters did not actually rely on the misrepresentation. Rather, the underwriters testified that they at least nominally knew prior to issuing the policies that American Capital had at least one subsidiary, its operating subsidiary, American Capital Financial Services.

The court then addressed coverage for SPL under American Capital's CGL policies. Importantly, those policies contained an endorsement that expanded the definition of "Named Insured" to include not only the entity listed in Item 1 of the Declarations—American Capital—but also "any organization, other than a partnership or joint venture, over which you maintain ownership or majority interest on the effective date of the policy." While the insurers argued that SPL did not qualify under this language, stating that "majority interest" extended coverage only to an organization in which the named insured maintained a direct or controlling interest, the court found ambiguity in the term "majority interest." The court explained that reading a requirement of control or absolute ownership into the language would render the "majority interest" language superfluous, and that under Maryland law, given the ambiguity, the term must be construed against the insurer as drafted and in favor of the insured. The court also dismissed the insurers' arguments that the intent of this provision was not to expand coverage to include all or some of the insured's portfolio companies. While the underwriters may not have fully appreciated the coverage implications of this language in a policy issued to a private equity firm, the court explained that the insurers failed to show that the narrower definition of "majority interest" was intended when the form was drafted. Accordingly, the court interpreted the term to mean a financial interest greater than 50 percent, and concluded that American Capital had a majority of the total equity value in SPL during the relevant time period. Thus, the insurers owed SPL a duty to defend the heparin litigation and had breached that duty.

The insureds sought over $62 million in damages for the insurers' breach, representing attorneys' fees and other litigation expenses incurred in defense of the heparin litigation between January 18, 2009 (the date of the denial and when the coverage litigation commenced) and June 14, 2016. Although the insurers argued that litigation expenses must be allocated between (1) covered and uncovered claims and (2) between covered and uncovered parties, the court disagreed. Citing extensive Maryland authority, the court explained that "[a]ttorneys' fees awarded for breach of a liability policy's duty to defend are not allocated between covered and uncovered claims because, under Maryland's potentiality rule, if any

[1] The court also rejected the insurers' argument that the financial services exclusion applied, explaining that the suits against American Capital generally alleged that American Capital itself was negligent or liable under a strict liability theory, rather than claims premised on American Capital's provision of financial services.

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claims potentially come within the policy coverage, the insurer is obligated to defend all claims notwithstanding alternative allegations outside the policy's coverage." Thus, assuming certain suits contained uncovered and covered allegations, allocation between those allegations or claims would be inappropriate.

More importantly, the court held that allocation between the over 1,000 heparin suits was likewise inappropriate, even where some of the lawsuits alleged that the joint venture was the source of the contaminated heparin. "The heparin suits, which not only involved interrelated facts but were consolidated in a multidistrict litigation and a consolidated state action, had to be considered collectively." Because the suits were not only reasonably related, but also "inextricably intertwined," the court held that the defense costs should not be allocated between suits and awarded to American Capital and SPL $62,717,069 plus prejudgment interest, for the fees and litigation expenses incurred in defense of the heparin litigation between January 18, 2009 (the date of the coverage denial) and June 14, 2016.

Implications

The Maryland District Court's opinion is an important reminder of the breadth of a general liability insurer's duty to defend. While the court declined to find the insurers acted in bad faith, the insurers were nonetheless on the hook for all defense costs incurred by American Capital and SPL in the heparin litigation without allocation, plus prejudgment interest. Policyholders, therefore, should look out for attempts by insurers to allocate defense costs between uncovered and covered claims, or even uncovered and covered suits in a multidistrict litigation setting, where such a right to allocation is not expressly included in the policy. Furthermore, because an insurer's duty to defend is determined (at least in Maryland) by the potentiality standard, the insurer is liable for the entire cost of defense.

Finally, the ruling is important for private equity insureds who may have previously overlooked coverage for their portfolio companies under their own commercial general liability policies. Indeed, many CGL policies include language like that in the Travelers forms at issue here, that expands the definition of "Insured" or "Named Insured" to include entities that the insured has a majority interest in. Other courts may similarly find that the language is ambiguous and must be interpreted in favor of coverage, or may even find that this language necessarily contemplates coverage for portfolio companies.

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