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INSURANCE LAW AND INVESTMENT MANAGEMENT

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HEDGE, PE AND VC FUNDS, BE WARNED: INSURANCE COMPANIES DISCLAIM COVERAGE

By: Robert D. Chesler, Esq., Michael David Lichtenstein, Esq., and Peter D. Greene, Esq.

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The decision in *Charter Oak Fire Insurance Company, et al. v. American Capital, Ltd.*, No. 8:09-cv-00100-DKC (D. Md. March 9, 2011) exemplifies the trouble in which a private equity firm can become embroiled if it does not coordinate its insurance coverage. While many of the underlying facts remain unclear, it appears that American Capital, Ltd. ("American Capital"), a publicly traded private equity firm with over \$23 billion in assets under management, invested in Scientific Protein Laboratories, LLC ("SPL"). SPL allegedly sold a tainted drug (Heparin), resulting in more than 100 lawsuits against American Capital and SPL. Both companies sought coverage under American Capital's general liability insurance policies issued from 2006 to 2009.

In response, the insurers sued both companies, seeking, *inter alia*, rescission and reformation of the policies. The insurers asserted that American Capital's applications for insurance policies were filled with relevant misrepresentations. The insurers alleged that:

- American Capital did not have any subsidiaries;

- that even though it acquired SPL in 2006, its application in 2008 stated that it had not made any acquisitions in the prior five years;
- that even though it had received a Heparin complaint prior to 2008, it stated that there had not been any product liability loss in the prior three years;
- that even though Heparin had been recalled, American Capital stated that none of its products had been recalled;
- that it did not do business in China, where Heparin was manufactured;
- that even though it had stated in the Heparin litigation that Heparin was processed by a joint venture, it had said no when asked on its application if it was involved in joint ventures; and
- that it failed to reveal the Heparin suits on its 2008 application.

In addition, American Capital allegedly entered into settlement agreements with its United States distributor for Heparin and co-defendant in many of the Heparin lawsuits, Baxter International, Inc. and Baxter Healthcare Corporations, without notifying its insurers or asking the insurers to approve it.

We presume that American Capital was not engaged in a massive insurance fraud. It is more probable that American Capital was engaged in a massive misunderstanding involving a complete failure of communication among its own management, its risk manager and its insurance broker. It appears that the risk manager and the broker thought the insurance policies applied only to American Capital itself, while management thought the policies also covered its portfolio companies.

American Capital's troubles continued. Its insurance policies provided coverage for companies in which it had an "ownership or majority interest." In the coverage litigation, American Capital asserted that SPL was a subsidiary and therefore covered. However, in the product liability litigation, American Capital stated that SPL was a subsidiary of SPL Acquisition Corporation, which in turn represented that it had no parent.

Insurance Law and Investment Management

Charter Oak highlights the importance of proper coordination by hedge and venture capital funds, both large and small, when purchasing insurance. Purchasing a standard form policy is not the solution. Funds must review their operations, determine whether portfolio companies will be covered by the fund's policy or by individual policies, and do a thorough review before filling out the application. This requires careful coordination between the fund's management, risk manager, broker, and when possible, outside coverage counsel. Moreover, while *Charter Oak* addressed general liability policies, similar issues exist with directors and officers and employment practices liability insurance. A fund's personnel often wear two hats, one at the fund and one at a portfolio company. The

fund must carefully customize its insurance policies to make certain that individuals are fully covered in all of their positions, and that no one has fallen through the cracks.

Charter Oak also underscores the importance of coordinating litigation and insurance recovery efforts. Admissions that an insured makes in litigation can often have a major impact (both positive and negative) on the availability of insurance coverage. Therefore, before an insured takes any affirmative position in litigation, it should consult its risk manager and/or outside insurance coverage counsel to evaluate the potential impact on insurance coverage.

Please contact any of the following attorneys with questions related to this alert:

Robert D. Chesler

Co-Chair, Insurance Law Group
rchesler@lowenstein.com
973 597 2328

Michael David Lichtenstein

Co-Chair, Insurance Law Group
mlichtenstein@lowenstein.com
973 597 2408

Joseph D. Jean

Member, Insurance Law Group
jjean@lowenstein.com
973 597 6906

Peter D. Greene

Vice Chair, Investment
Management Group
pgreene@lowenstein.com
646 414 6908

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www.lowenstein.com

New York

1251 Avenue of the Americas
New York, NY 10020
212 262 6700

Palo Alto

590 Forest Avenue
Palo Alto, CA 94301
650 433 5800

Roseland

65 Livingston Avenue
Roseland, NJ 07068
973 597 2500