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Implications Of Flagship Credit V. Indian Harbor

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The Fifth Circuit recently held that coverage for statutory class action claims against a financial institution is not excluded under the definition of “loss” in a contract for liability insurance. *Flagship Credit Corp. v. Indian Harbor Ins. Co.*, No. 11-20408, (5th Cir. June 15, 2012).

Background

In December 2009, plaintiffs initiated a class action in Pennsylvania alleging that Flagship Credit Corporation, which provides automobile financing in Texas, had failed to provide class members with adequate notice of default as required by the Texas Business and Commerce Code. The suit sought the minimum damages available under the Texas statute, which amounted to “the credit service charge plus 10 percent of the principal amount of the obligation or the time price differential plus 10 percent of the cash price.”

Flagship tendered the lawsuit to its liability insurer, Indian Harbor Insurance Company, requesting a defense and indemnification. Indian Harbor defended Flagship in the class action but reserved its right to deny coverage to the extent any amounts that Flagship became obligated to pay did not constitute “loss” as that term was defined in the insurance contract. The policy defined “loss” to not include “fines, penalties or taxes imposed by law.” After Flagship settled with the plaintiffs, Indian Harbor refused to indemnify Flagship for the settlement. Indian Harbor contended that the settlement constituted a penalty and, thus, was not a “loss” under the policy.

Flagship sued Indian Harbor, alleging breach of contract and seeking a declaration that the amounts paid under the settlement constituted “loss” under the policy. Explaining that the minimum damages available under the Texas statute were a penalty, the district court concluded that the amounts paid in settlement were not covered. Flagship appealed to the U.S. Court of Appeals for the Fifth Circuit.

The Appeal

On appeal, Flagship argued that because fines and taxes are amounts paid to the government, the court should read the term “penalties,” which is used in the policy in conjunction with the terms “fines” and “taxes,” in a similar manner such that a penalty likewise would require that the amount be paid to the government. Flagship further argued that because the settlement at issue here was not paid to the government, the payment did not constitute a penalty. Indian Harbor, in response, argued that Flagship’s construction effectively added words to the contract, which according to Indian Harbor, plainly and broadly excluded coverage for “fines, penalties or taxes imposed by law.”

Applying Texas law, the Fifth Circuit found that the minimum damages under the Texas statute were not a penalty and, therefore, were not excluded from coverage under the policy’s definition of “loss.” The court rejected Indian Harbor’s position, relying instead on established canons of insurance contract construction. The court reasoned that while words can have multiple

meanings, it is the context in which a word is used that determines what that word should mean. Here, the court utilized the canon of contract construction *noscitur a sociis*, which requires that consistent meanings be given to words that are grouped together. Thus, because the term “penalties” was grouped with the words “fines” and “taxes,” the court explained it was constrained to construe the words consistently.

According to the court, fines are criminal punishments or civil penalties and that in either case, the amounts are payable to a “public treasury.” The court found that taxes also are governmental receipts. The court further noted that “penalties” often refer to “punishments for criminal matters.” Thus, the court found that the “common meaning, though not the exclusive meaning, of all three terms involves a payment to the government.”

The court concluded, therefore, that the “term ‘penalties’ as used in the phrase, ‘fines, penalties or taxes’ is limited to payments made to the government.” Consequently, because the payments made by Flagship were to the class members, the court found that the payments did not come within the scope of the excluded categories under the definition of “loss.”

Implications

The Fifth Circuit’s decision in Flagship highlights the significance of the insurance contract and the manner in which terms are used within that contract. Thus, it is not always the case that where multiple reasonable meanings can be attributed to a term, that the term necessarily is ambiguous. Rather, the term must be viewed in context and accorded its plain and ordinary meaning so that it is construed in a manner consistent with the context in which the term is used in the contract.

The Flagship decision also serves as a reminder of the potential for coverage under professional liability insurance policies for losses arising out of financial transactions and allegedly improper banking practices. The decision underscores the importance that policyholders carefully evaluate all potentially available insurance coverages when faced with any type of loss.

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