

# BINDING AUTHORITY

Insurance Coverage Decisions: Issued Today - Impact Tomorrow



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I am both excited and frustrated to report that “**General Liability Insurance Coverage – Key Issues in Every State**” is “**Sold Out**” on [Amazon.com](http://Amazon.com). Indeed, it is a real Good News – Bad News situation. “Key Issues” is the Cabbage Patch Doll of insurance books. The book is expected to be back in stock at Amazon very soon and you can still order it there. The book is currently on sale at the [Oxford University Press](http://Oxford University Press) site (despite the suggestion on the site that it is also temporarily out of stock there – long story). Use promo code 30550 on the OUP site to save 20. Thanks for your patience.

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## ***Binding Authority: The All-Business Issue***

### **Eastern District of Pennsylvania Issues a Significant *Kvaerner/Gambone* Decision**

### **Fourth Circuit Court of Appeals Issues the Most Significant Coverage Decision of 2012 -- Addressing Coverage for Pre-Existing Duties**

This will be an all-business issue of *Binding Authority*. The two cases to be discussed are just too important to have it any other way. This a serious stuff. So there will be no silly jokes. No Sophomoric comments. No comments about my (wonderfully understanding) wife. If you only read *Binding Authority* for the first paragraph (and my market research shows that that’s 42% of you), then stop here. Without delay -- To the business at hand...

Actually, truth be told – this whole all-serious thing is completely made-up and a cover for the fact that I just couldn’t think of anything funny to say. I have spent so much energy over the past two weeks trying to come up with Jeremy Lin puns that I have no creative juices left in the tank.

Now, to the business at hand...First, on February 24, the Eastern District of Pennsylvania issued a significant decision addressing coverage for construction defects in Pennsylvania (read as – *Kvaerner* and *Gambone*). Second, in a decision with more national implications, the Fourth Circuit Court of Appeals just issued what I believe to be the most

significant insurance coverage decision to date in 2012 – addressing an insurer’s obligation for pre-existing duties.

**February 24 – *Westfield Insurance Company v. Bellevue Holding Company*.** The Eastern District of Pennsylvania, relying on the principles of *Kvaerner* and *Gambone*, held that no coverage was owed to property developers for a defense or indemnity for actions alleging construction defects at a residential community that it built. The case involved eight underlying homeowner actions and six policies.

Of significance is the detail in the opinion. The court’s opinion is 32 pages and describes in some detail numerous Pennsylvania decisions that have addressed the “occurrence” issue post- *Kvaerner* and *Gambone*. While the court held that no coverage was owed, it also discussed some situations where the court believes that coverage may be owed. *Westfield Insurance Company v. Bellevue Holding Company* is a must-read for those involved in Pennsylvania construction defect coverage and who have been dealing with *Kvaerner* and *Gambone* issues. Copy attached. Full disclosure – My colleagues here at White and Williams represented Westfield Insurance Company.

**February 24 – *Republic Franklin Ins. Co. v. Albemarle County School Board*.** The Fourth Circuit Court of Appeals addressed coverage for an insured’s pre-existing duty. In other words, when coverage is sought for business obligations that an insured otherwise had. This is an issue that arises frequently, especially in the context of professional liability claims.

Six employees of the Albemarle County School Board -- bus drivers or “transportation assistants” hired to maintain and clean buses -- commenced an action against the School Board under the Fair Labor Standards Act (FLSA), asserting that they “were not paid for all of the time that they worked and that they were not paid at the premium overtime rate when they worked for more than 40 hours in a week. They demanded, among other things, unpaid wages and overtime pay, liquidated damages as authorized by the FLSA, and attorneys’ fees. As of July 2010, approximately 90 present and former employees had opted into the action.” *Albemarle* at 3.

The School District sought coverage under a professional liability policy issued by Republic Franklin Ins. Co. Republic Franklin undertook the School District’s defense under a reservation of rights and filed an action requesting a declaratory judgment that it did not have a duty to defend or indemnify the School Board for any judgment that the School Board might be required to pay. *Id.*

The District Court found in favor of Republic Franklin. Succinctly stated, the District Court held:

[T]he “insured’s negligent, willful, or intentional failure to honor a pre-existing obligation to pay money is not a ‘wrongful act’ as that term is used in the policy.... To find otherwise could encourage parties to routinely circumvent the requirements of the FLSA—whether negligently, willfully, or intentionally—because they have nothing to lose.” ... The court also found that because the claim for back wages was not a claim for “damages,” as required by the definition of loss, but rather an existing operating cost, so

too was a claim for the liquidated damages and attorneys' fees not a loss "because that claim did not exist independently of the claim for back wages."

*Id.* at 4.

The case went to the Fourth Circuit Court of Appeals, where it was not as clear cut.

First, the Fourth Circuit agreed (and the School District did not dispute) that the obligation to pay back wages and overtime under the FLSA is not covered because such sums are not "losses" under the policy. The School District conceded that "the obligation to pay back wages and overtime pay is a preexisting duty that was not the result of its wrongful act in allegedly violating the FLSA." *Id.* at 9.

The bigger dispute was whether the other financial consequences resulting specifically from the violation of the FLSA -- in the form of liquidated damages and attorneys' fees -- would be losses covered by the policy." *Id.*

The Fourth Circuit held that coverage was owed for the liquidated damages and attorneys' fees under the FLSA. The underpinning of the court's decision was the difference between "wrongful act" and "loss," as those terms were used in the policy. The court held that "[w]hile a preexisting duty might be relevant to whether an insured suffers an insurable *loss*, it cannot be relevant to whether the insured is the subject of a claim for a *wrongful act*." *Id.* at 7 (emphasis in original). "Every duty breached or violated is necessarily a preexisting duty, and it is the *breach* or *violation* of that duty which constitutes a wrongful act. And, this is precisely how the insurance policy in this case defines a wrongful act: 'Wrongful act' means *any breach of duty*, neglect, error, [or] omission." *Id.* (emphasis in original).

Following a review of some frequently seen cases nationally on this issue, the court set down this conclusion:

In sum, these cases— *Pacific Insurance*, *May Department Stores*, and *Oktibbeha County*—stand for the proposition that a judgment ordering an insured to pay money that the insured was already obligated to pay, either by contract or by statute, is not a "loss" covered under an insurance policy that requires that the loss be caused by a "wrongful act." The alleged "loss" in such cases arises from the contract or the statute itself, not from the failure to abide by it. These cases do not stand for the proposition that the failure to comply with a preexisting duty cannot be a "wrongful act." Such a rule would not only be incompatible with the definition of "wrongful act" in such policies—defined broadly to include "any breach of duty"—but also is counterintuitive because no violation of the law could ever be a "wrongful act" as there would always be a preexisting duty to follow the law.

*Id.* at 8-9.

Having concluded that the violation of the FLSA was a "wrongful act," the court turned to the question whether the associated liquidated damages and attorneys' fees qualified as "loss" (notwithstanding that it concluded that wages and overtime owed under the FLSA were not "loss" because it was a pre-existing duty).

Franklin Insurance argued that liquidated damages and attorneys' fees could not be "loss" under the policy for the following reasons: "(1) they are inextricably connected with the claims for back wages and overtime pay, which themselves do not create losses, and thus none of these damages can be covered losses; (2) they are 'fines or penalties imposed by law' and therefore excluded by the terms of the policy; and (3) they are restitutionary in nature and therefore not 'damages,' as required by the policy's definition of 'loss.'" *Id.* at 9.

The court rejected these arguments. First, the court concluded that the liquidated damages and attorneys' fees arose not from a preexisting duty, but because of the School Board's alleged wrongful acts. *Id.* at 10. The court also held that, based on controlling Supreme Court precedent, liquidated damages as authorized by the FLSA are not penalties but rather compensatory damages "for the retention of a workman's pay which might result in damages too obscure and difficult of proof for estimate other than by liquidated damages." *Id.* Therefore, the liquidated damages and attorneys' fees were not excluded as fines or penalties or for being restitutionary in nature.

*Republic Franklin Ins. Co. v. Albemarle County School Board* supports the conclusion – a not uncommon one -- that coverage does not exist for an insured's pre-existing duties, *i.e.*, the business obligations that an insured otherwise had. The take-away from *Albemarle County* is that the same conclusion may not be reached for obligations that flow from the insured's pre-existing duty. However, this is by no means a blanket proposition. The nature of the collateral obligations and specific terms of the policy are likely to be important considerations here. Given the frequency in which this issue arises, that there is not an abundance of case law nationally on the issue and the detail provided by the Fourth Circuit – in a published opinion and one addressing cases nationally -- *Albemarle County* is a significant decision.

A copy of *Republic Franklin Ins. Co. v. Albemarle County School Board* can be accessed here:

<http://pacer.ca4.uscourts.gov/opinion.pdf/101961.P.pdf>

Please let me know if you have any questions.

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