

THOUGHT LEADERSHIP

News

FIFTH CIRCUIT REVERSES AND REMANDS JUDGMENT ON PLEADINGS AND DISMISSAL OF SPEC'S SUIT AGAINST HANNOVER INSURANCE FOR CREDIT CARD HACKER DEFENSE

Newsbrief

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Last week, the United States Court of Appeals, Fifth Circuit issued its opinion in *Spec's Family Partners, Limited v. Hannover Insurance Company*, No. 17-20263, 2018 WL 3120794 (5th Cir. Jun. 25, 2018). Spec's sued Hannover Insurance for refusing to pay its attorney's fees and expenses in defense of a suit relating to the hacking of Spec's credit card networks between 2012 and 2014. The Fifth Circuit found, based on the underlying insurance policy, that the trial court erred in rendering judgment on the pleadings and dismissing Spec's suit against Hannover, remanding the case back to the Southern District of Texas.

Spec's is a well-known retail chain based in Houston, Texas who fell victim to credit card hackers between 2012 and 2014. Spec's used First Data Merchant Services, LLC to process its credit cards pursuant to a Merchant Agreement between the two companies. As a result of the breach, First Data was required to reimburse banks the costs associated with the fraudulent transactions. In December 2013, First Data sent a demand letter to Spec's claiming Spec's breached the "cardholder environment" and alleged Spec's failed to abide by the Payment Card Industry Data Security standard requirements. As a result of case management fees, fines, and reimbursement costs, First Data set a reserve account in the amount of \$7,624,846.21 and demanded documents from Spec's reflecting its security compliance. In March 2015, First Data sent another demand letter repeating its allegations from the first letter and notified Spec's of an additional reserve account in the amount of \$1,978,019.49. First Data alleged that both reserve amounts reflected Spec's indemnification obligations under the Merchant Agreement.

Spec's provided its insurance carrier, Hannover Insurance, with timely notice of the demand letters and Hannover eventually agreed to defend Spec's under a reservation of rights—entering into a "defense funding agreement" to hire counsel and reimburse Spec's for costs previously incurred in defending the claims. To recover the money First Data withheld in the reserve accounts, Spec's sued First Data in Federal court in Tennessee. Hannover refused to pay the expenses associated with the Tennessee suit, claiming they were not "defense expenses." As a result, Spec's sued Hannover in the underlying matter for: (1) breach of the insurance policy; (2) breach of the Defense Funding Agreement, (3) violation of Section 542 of the Texas Insurance Code and (4) sought a declaratory judgment that Hannover has an ongoing duty to pay defense costs. Hannover moved for judgment on the pleadings claiming a

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policy exclusion (Exclusion-“N”)—providing that the underlying policy does not apply to a loss resulting from a claim based upon liability under a written or oral contract or agreement—foreclosed Hannover’s duty to defend or indemnify Spec’s since the liability arose from the Merchant Agreement between Spec’s and First Data. The district court granted Hannover’s motion and dismissed all of Spec’s claims based on the insurance policy’s Exclusion-N. Spec’s appealed.

The Fifth Circuit reviewed the underlying policy considering Hannover’s obligations under both the duty to defend and duty to indemnify. The Court noted that Hannover’s duty to defend turned on whether First Data’s demand letters contained at least one claim that fell within the scope of coverage under Spec’s insurance policy. The Court concluded that this obligation was triggered if the Claim from First Data included the potential for liability on a non-contractual ground, even if the claim also included contractual liability that would have been excluded by Exclusion-N.

The Court found that the demand letters from First Data included references to Spec’s alleged non-compliance with duties outside of the Merchant Agreement. Because claims were made that fell outside of the exclusion, the Court found the District Court erred in rendering judgment on the pleadings. Furthermore, the Fifth Circuit also found the District Court erred in entering judgment on the pleadings on Spec’s claims of Hannover’s breach of the Defense Funding Agreement as Hannover never mentioned the agreement in its motion for judgment on the pleadings—arguing only that the Policy excluded its obligation from defending Spec’s.

As a result, the Fifth Circuit reversed and remanded the district court’s judgment.