

**Capital Z Financial Services Fund II, LP v Health Net,
Inc.**

2006 NY Slip Op 30199(U)

May 4, 2006

Supreme Court, New York County

Docket Number: 0603375/2003

Judge: Helen E. Freedman

Republished from New York State Unified Court
System's E-Courts Service.
Search E-Courts (<http://www.nycourts.gov/ecourts>) for
any additional information on this case.

This opinion is uncorrected and not selected for official
publication.

SUPREME COURT OF THE STATE OF NEW YORK -- NEW YORK COUNTY

PRESENT: _____

PART _____

Justice

CAPITAL 2 FINANCIAL SERVICES FUND II

INDEX NO.

603375/03

MOTION DATE

MOTION SEQ. NO.

002

MOTION CAL. NO.

HEALTH NET, INC.

The following papers, numbered 1 to _____ were read on this motion to/for _____

PAPERS NUMBERED

Notice of Motion/ Order to Show Cause -- Affidavits -- Exhibits ...

Answering Affidavits -- Exhibits _____

Replying Affidavits _____

Cross-Motion: Yes No

Upon the foregoing papers, it is ordered that this motion

is decided in accordance with accompanying memo of law

FILED
MAY 05 2006
NEW YORK COUNTY CLERK'S OFFICE

Dated: _____

May 4, 2006

[Signature]

J.S.C.

Check one: FINAL DISPOSITION NON-FINAL DISPOSITION

Check if appropriate: DO NOT POST REFERENCE

MOTION/CASE IS RESPECTFULLY REFERRED TO JUSTICE FOR THE FOLLOWING REASON(S):

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: PART 39

----- X

CAPITAL Z FINANCIAL SERVICES FUND II,
L.P., a Bermuda limited partnership, CAPITAL Z
FINANCIAL SERVICES PRIVATE FUND II, L.P.,
a Bermuda limited partnership, INSURANCE
PARTNERS, L.P., a Delaware limited partnership,
and INSURANCE PARTNERS OFFSHORE
(BERMUDA), a Bermuda limited partnership,

Index No. 603375/03

Plaintiffs,

- against -

HEALTH NET, INC., a Delaware corporation,

Defendant.

FILED
MAY 05 2006
NEW YORK
COUNTY CLERK'S OFFICE

FREEDMAN, J.:

In this action, plaintiffs allege *inter alia* that defendant Health Net, Inc.'s predecessor, Foundation Health Systems, Inc. (FHC), breached a contract in connection with plaintiffs' financing the purchase by Superior National Insurance Company (Superior) of Business Insurance Group (BIG), a collection of four worker's compensation carriers. Plaintiffs, commenced this action, claiming that Health Net, Inc. ("Health Net") misrepresented the extent of BIG's reserves to cover anticipated workers' compensation claims, and that these misrepresentations caused them to sustain monetary damages. The complaint sets forth causes of action in breach of contract, breach of the covenant of good faith and fair dealing, fraudulent inducement, and fraud.

Health Net now moves, pursuant to CPLR 3211 (a) (1), 3211 (a) (3), and 3211 (a) (7), for dismissal of the complaint, on the grounds of a defense founded upon documentary evidence,

lack of legal capacity to sue, and failure to state a cause of action, respectively. For the reasons set forth below, the motion is granted to the extent of dismissing the second, third, and fourth causes of action sounding in breach of the covenant of good faith and fair dealing, fraudulent inducement and fraud.

Factual Background and Allegations

Plaintiffs Capital Z Financial Services Fund II, L.P. (CZF Fund) and Capital Z Financial Services Private Fund II, L.P. (CZF Private Fund) are Bermuda limited partnerships. Plaintiff Insurance Partners (IP) is a Delaware limited partnership. Plaintiff Insurance Partners Offshore (Bermuda), L.P. (IP Offshore) is a Bermuda limited partnership. Plaintiffs are collectively referred to as Cap Z. Health Net, now the defendant, is a Delaware corporation.

In early 1998, Cap Z entered into discussions with Health Net about the possibility of acquiring BIG. Based upon information that Health Net provided to Cap Z, the latter determined that BIG's loss and lost adjustment expense reserves were adequate.

The parties signed a Purchase Agreement on May 5, 1998, and the BIG acquisition took place on December 10, 1998 with Cap Z financing 75% of the \$285 million acquisition price by purchasing newly-issued shares of Superior stock through transactions that closed together with the Purchase Agreement.

As part of the execution of the May 5, 1998 Purchase Agreement, Health Net entered into voting agreements, (Voting Agreements) with IP and IP Offshore, together Superior's largest single shareholder, that provided that Health Net could vote IP's and IP Offshore's shares in Superior in favor of any proposal submitted to Superior's shareholders necessary for the successful closing of the BIG acquisition.

Alleged Misrepresentations

BIG, as a worker's compensation carrier, was required by California law to maintain "loss reserves" and "loss adjustment expense reserves" for the purpose of paying out anticipated claims by insurance policyholders. In 1998, Health Net or BIG increased BIG's loss and expense reserves for the period ending December 31, 1997 to \$521.6 million, based on a March 4, 1998 report prepared by an independent actuarial service, Milliman & Robertson, Inc. (M&R Report). However, Superior and Cap Z commissioned other reports suggesting that the M&R Report underestimated BIG's anticipated liabilities for claims and expenses. Hence, as a condition for the acquisition, Health Net or BIG was required to obtain an insurance policy covering potential reserve deficiencies for Superior. After the execution of the Purchase Agreement, M&R recalculated its reserve estimates, but neither Superior nor Cap Z was ever informed of the results of the recalculations.

Prior to the execution of the Purchase and Voting Agreements, Health Net or BIG obtained a "Reserve Cover" from American Reinsurance Company (American Re), after providing American Re with a copy of the M&R Report, but concealing from American Re the same reserve deficiencies that it concealed from Cap Z. Health Net also misrepresented BIG's (1) "captive insurance programs" (Captive Programs) and (2) accounts receivables.

According to the Complaint in June 1999, American Re refused to honor its obligations under the Reserve Cover, because of Health Net's misrepresentation and omissions. By 2000, BIG's reserve deficiency at the time of the December 1998 closing was determined to have exceeded \$400 million and Superior was forced to settle with American Re. On March 3, 2000,

California insurance regulators seized Superior's insurance companies, including BIG after BIG and Superior became insolvent.

The complaint contains four causes of action. The first cause of action alleges that Health Net breached express warranties and covenants of the Purchase Agreement by intentionally understating BIG's liabilities and the financial health of BIG's Captive Programs. Paragraph 5.1 of the Purchase Agreement requires Health Net to indemnify Cap Z, as an affiliate of Superior, and hold it harmless with respect to any losses sustained because of breach of a representation contained in the agreement.

The second cause of action alleges that Health Net breached the implied covenant of good faith and fair dealing implicit in the Voting Agreements by (a) making misrepresentations regarding the reserves, Captive Programs, and accounts receivable of BIG, and (b) thereby intentionally depriving IP and IP Offshore of the benefits that they expected from the agreement to have their shares voted in favor of all proposals necessary to complete the BIG Acquisition.

The third cause of action alleges that Health Net intentionally misrepresented BIG's reserves, Captive Programs, and accounts receivable to induce IP and IP Offshore to enter into the Voting Agreements.

The fourth cause of action alleges that Health Net intentionally made misrepresentations to Cap Z regarding BIG's reserves, Captive Programs, and accounts receivable to induce Cap Z to finance seventy percent of the BIG acquisition.

Discussion

Health Net first argues that all of the claims should be dismissed, because they are "derivative," not "direct," and, therefore, Cap Z may not sue in its own behalf but must assert

claims derivatively, on Superior's behalf. Specifically, Health Net contends that Cap Z, as a stockholder in Superior, suffered a loss as a result of Superior's decline in value, and that, to prevail, it must prove that Health Net's alleged misrepresentations about BIG's financial health caused this decline. Health Net argues that, under applicable Delaware law, the right to assert the claims alleged in this action belongs to Superior, and not to Cap Z.

It is undisputed that whether Cap Z has standing to assert the above-stated claims against Health Net is governed by Delaware law inasmuch as Delaware is Superior's state of incorporation (*Matter of CPF Acquisition Co. v CPF Acquisition Co.*, 255 AD2d 200 [1st Dept 1998]; *Graczykowski v Ramppen*, 101 AD2d 978 [3d Dept 1984]). Also the Purchase Agreement and the Voting Agreements each provide that the laws of Delaware shall govern "all issues concerning the validity of this Agreement, the construction of its terms and the interpretation and enforcement of the rights and duties of the parties." New York courts enforce choice of law provisions in contracts (*Indosuez Intl. Fin., B.V. v National Reserve Bank*, 304 AD2d 429 [1st Dept 2003]; *Micro Balanced Prod. Corp. v Illavin Indus. Ltd.*, 238 AD2d 284 [1st Dept 1997]), particularly where the choice of law provision bears a reasonable relationship to the Purchase Agreement, and does not violate fundamental public policy of this state (*Finucane v Interior Constr. Corp.*, 264 AD2d 618 [1st Dept 1999]).

Under Delaware law, whether a claim is "derivative" or "direct" depends upon (1) who suffered the alleged harm – the corporation or the individual stockholder – and (2) who would receive the benefit of the recovery or other remedy (*Tooley v Donaldson, Lufkin, & Jenrette*, 845 A2d 1031 [Del 2004]).

If the claim were derivative, as a Superior shareholder, Cap Z would be required to comply with the requirements of Delaware Court of Chancery Rule 23.1 which provides that the stockholder (a) retain ownership of the shares throughout the litigation, (b) make presuit demand on the company's board of directors, and (c) obtain court approval of any settlement. In addition, any recovery would be paid directly to Superior, not Cap Z (*Tooley v Donaldson, Lufkin, & Jenrette*, 845 A2d 1031, *supra*).

However, the claims are direct because the complaint as set forth upon misrepresentations that Health Net allegedly made to Cap Z, as well as to Superior. The complaint alleges that Cap Z has been directly harmed as a contractual "affiliate" of Superior. Section 8.4 (a) of the Purchase Agreement defines "affiliate" as having the meaning set forth in Rule 12b-2 of the Securities Exchange Act of 1934, as amended. Cap Z appears to be an affiliate by virtue of its significant holdings of shares of Superior.

To be sure, a claim is not direct simply because it is pleaded that way (*Dieterich v Harrer*, 857 A2d at 1027). Here, however, in addition to Cap Z's claimed status as an "affiliate" set forth in the Purchase Agreement, Cap Z is expressly named in Section 3.5 of the agreement, wherein Superior makes representations as to Cap's financing of the BIG acquisition. Thus, the complaint adequately alleges that the breach was directly at Cap Z directly, and not merely as a shareholder of Superior (*cf. Dieterich v Harrer*, 857 A2d 1017, 1027 [Chancery Ct, Del 2004] [duty allegedly breached was owed to corporation, not to individual stockholder]).

That the same set of facts could also support a claim by Superior, does not make the claim any less direct as to Cap Z (*Grimes v Donald*, 673 A2d 1207, 1212 [Del 1996]), because the allegations contained in the complaint suggest that Cap Z can prevail without showing injury

to Superior (*In re Syncor Intl. Corp. Shareholders Lit.*, 857 A2d 994 [Chancery Ct, Del 2004]). Thus, it is inconsequential that Superior's claims against Health Net may have been extinguished by the Los Angeles Bankruptcy Court's December 29, 2003 order that approved Superior's settlement and release of all claims against Health Net.

Health Net next argues that, even if Cap Z has standing to bring this action, the court should dismiss each cause of action on other grounds. It contends that the first cause of action for indemnification, under Section 5.1 of the Purchase Agreement, fails, because Cap Z did not timely seek indemnification as required by Section 5.3, which provides, in part:

“The several representations and warranties of the parties contained in this Agreement or in any instrument delivered pursuant to this Agreement will survive the Closing Date and will remain in full force and effect thereafter for a period of one year from the Closing Date;”

Health Net argues that, because the acquisition's “Closing Date” was in December 1998, the action is untimely in that Cap Z did not notify Health Net of its indemnification claim until it filed this action on October 28, 2003, almost five years later.

Parties may agree to limit the period of time within which an action must be commenced to a shorter period than that provided by the statute of limitations (*Matter of Inc. Vil. of Saltaire v Zagata*, 280 AD2d 547 [2d Dept 2001], provided that they clearly and unambiguously express their intent to do so (*DiPietro v Feldman-Mondlick, Inc.*, 6 AD3d 1216 [4th Dept 2004]). Here, although Section 5.3 provides that the representations set forth in the sued-upon Section 5.1 survive for a one-year period, that contractual provision does not limit time within which to commence an action (*cf. Hovde Acquisition, LLC v Thomas*, 2002 WL 1271681 [Chancery Ct, Del 2002] [paragraph 9 of the controlling agreement expressly provided that the right of the parties to seek indemnification shall survive for two years from the date of the Closing]).

Failure to comply with Section 5.4 provisions, which require a party claiming an indemnifiable event under Section 5.1 (as is the case here), or Section 5.2, to “promptly” notify the other party of an indemnification obligation does not relieve the indemnifying party of its contractual obligations in the absence of resulting prejudice from late notice.

The second cause of action alleges that Health Net breached the implied covenant of good faith and fair dealing implicit in the Voting Agreements by (1) making misrepresentations regarding BIG’s reserves, Captive Programs, and accounts receivables, and (2) thereby intentionally depriving IP and IP Offshore of the benefits that they reasonably expected from their agreement to permit their shares to be voted in favor of all proposals necessary to complete the BIG acquisition.

Delaware recognizes a cause of action based upon the implied covenant of good faith and fair dealing contained in every contract (*see e.g. Brown v Liberty Mut. Ins. Co.*, 774 A2d 232 [Del 2001]). The unambiguous terms of the Voting Agreements, however, defeat these claims, in that they demonstrate that the implied covenant contained in those agreements was not breached (*Cincinnati SMSA Ltd. Partnership v Cincinnati Bell Cellular Sys. Co.*, 708 A2d 989 [Del 1998]). Health Net’s obligation under the Voting Agreements was to take all actions necessary to cause IP’s and IP Offshore’s proxies to be voted at any meeting of Superior stockholders in favor of all transactions contemplated by financing agreements relating to the Purchase Agreement, and to not consent to any amendment or modification to the Purchase Agreement that could adversely affect IP or IP Offshore. The complaint does not allege that Health Net took any actions adverse to these obligations.

Health Net next argues, persuasively, that the third and fourth causes of action, for fraudulent inducement (Voting Agreements) and fraud (the BIG acquisition), respectively, should be dismissed, because they are barred by a “no reliance” provision of the Purchase Agreement and by the “loss causation” rule. These causes of action are based upon the assertion that Health Net’s misrepresentations caused IP and IP Offshore to enter into the Voting Agreements and Cap Z to finance the BIG acquisition.

Under either New York or Delaware law, the fraud claims are not viable (*Valassis Communications v Weimer*, 304 AD2d 448 [1st Dept 2003], *lv denied* 2 NY3d 794 [2004]; *H-M Wexford LLC v Encorp, Inc.*, 832 A2d 129 [Chancery Ct, Del 2003]), and Health Net is entitled to dismissal of the fraud claims. Cap Z expressly agreed that it was not relying upon any representations as to BIG’s reserves in entering into the acquisition, and that Health Net would not be liable based upon any representations as to BIG’s reserves (*see* § 2.6 (c) [Health Net makes no representations or warranty regarding (1) the items set forth in Section 2.6 of the disclosure schedule to the Purchase Agreement and (2) its reserves for losses or loss adjustment expenses (including the adequacy of such reserves or liabilities)]; § 3.6 (a) [Health Net disclaims representations and warranties about the accuracy or completeness of any of the information provided or otherwise made available to the purchaser, its agents or affiliates, including the M&R Report]; § 3.6 (b) [Health Net not liable or responsible regarding specific representations and warranties except as specifically set forth]).

Cap Z argues that these disclaimers do not bar the fraud claims where, as here, the concealed information is peculiarly within the defendants’ knowledge, citing *Danann Realty Corp. v Harris* (5 NY2d 317 [1959]). Contrary to Cap Z’s assertion, *Danann Realty Corp. v*

Harris supports the finding that the fraud claim is untenable. Indeed, the claim that the concealed information was peculiarly within Health Net's knowledge is belied by Section 24 of the Complaint itself, which states that Superior and Cap Z questioned the M&R Report and commissioned four opinions regarding these conclusions, and that the additional opinions suggested that the M&R Report had underestimated BIG's anticipated liabilities for claims and expenses.

Furthermore, the complaint alleges that, in addition to the reserves, Health Net made misrepresentations about the Captive Programs and accounts receivables. Under the loss causation rule, however, Cap Z must show that the misrepresentations induced it to participate in the BIG acquisition, and that the misrepresentations directly caused its loss (*Water St. Leasehold LLC v Deloitte & Touche LLP*, 19 AD3d at 185). The complaint alleges that Cap Z's loss resulted from inadequate reserves which, as discussed above, is subject to the no-reliance disclaimer (§§ 2.6 and 3.6). Thus, pursuant to the loss causation rule, the complaint fails to allege that the misrepresentations about these items caused the loss (*Water St. Leasehold LLC v Deloitte & Touche LLP*, 19 AD3d 183, *supra*; *Laub v Faessel*, 297 AD2d 28 [1st Dept 2002]).

Finally, the request in the complaint for an award of punitive damages is stricken, because the alleged breach of contract – which is the only viable claim in this action – does not constitute a wrong directed at the public generally (*New York Univ. v Continental Ins. Co.*, 87 NY2d 308 [1995]; *Sherry Assoc. v Sherry-Netherland, Inc.*, 273 AD2d 14 [1st Dept 2000]).

Accordingly, it is

ORDERED that the motion by Health Net, Inc. to dismiss the complaint is granted to the extent of dismissing the second, third and fourth causes of action, and striking the claim for punitive damages; and it is further

ORDERED that Health Net, Inc. is directed to serve its answer to the complaint within 20 days after service upon it of a copy of this order with notice of entry.

Parties are directed to appear for a preliminary conference on June 13, 2006 in room 208 at 9:30 a.m.

Dated: May 4, 2006

ENTER:



Helen E. Freedman, J.S.C.

FILED
MAY 05 2006
NEW YORK
COUNTY CLERK'S OFFICE