

## **Goods Lost to Chapter 11 Closing Sale, Resulting “Sue and Labor” Expenses, Covered Under Ocean and Inland Marine Policy, According to Second Circuit Court of Appeals**

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Last month, the United States Court of Appeals for the Second Circuit [upheld](#) the Southern District of New York’s award of over \$2 million to policyholder, Fabrique Innovations, Inc., against its ocean cargo insurance carrier, Federal Insurance Company.

Federal issued an “all-risk” ocean cargo insurance policy to Fabrique for fabric and plush merchandise “temporarily in storage” at a warehouse owed by Hancock Fabrics. Fabrique’s goods were lost when Hancock liquidated its holdings—including Fabrique’s merchandise—as part of Hancock’s bankruptcy proceedings. Following the loss, Fabrique filed a claim under its policy with Federal. Federal denied the claim, citing various exclusions, including an exclusion for “loss, damage or expense caused by or resulting from willful misconduct, fraud or deceit,” which the insurer argued was triggered due to Hancock’s sale of the goods in violation of the parties’ third-party logistics agreement.

The Second Circuit affirmed the lower court’s ruling in favor of the policyholder, concluding that the loss of goods was covered under the policy by virtue of an endorsement, stating that Federal would “pay for direct physical loss or damage to merchandise in transit caused by or resulting from a covered peril while such merchandise is temporarily in storage. . . in anticipation of transit.” The policy defined “merchandise in transit” as “business personal property” belonging to Fabrique that was “shipped by or consigned to others for [Fabrique’s] account” in “intracompany shipments.” The court applied the common everyday meaning of “intracompany shipments” to include Fabrique’s goods because they were shipped and stored at the Hancock’s warehouse. Thus, the court agreed that the plain language of the policy covered the goods lost in the closing sales.

The court also rejected Federal’s reliance on the willful misconduct exclusion under the well-settled principle that the insurer carries the burden to demonstrate that its interpretation of the exclusion is the only reasonable construction. New York law requires that “willful acts” be tortious in nature, extending “well beyond” a simple breach of contract. Because Hancock’s liquidation of its holdings was merely intentional nonperformance of a logistics agreement rather than truly culpable, harmful conduct, as the court reasoned, the court found that the exclusion for willful misconduct did not apply.

In assessing the amount of covered damages, the Second Circuit also rejected Federal's argument that the award for Fabrique's "sue and labor" costs in litigating its claims in bankruptcy court should be reduced pro rata for Fabrique's recovery of lost profits. The court again turned to the plain language of the policy, which included "sue and labor coverage" for "charges reasonably incurred" in the policyholder fulfilling its duty to take "all reasonable measures to avert or minimize loss or damage." Fabrique's sue and labor expenses fit within that definition because they were a direct result of its loss of goods and saved federal money on storage coverage obligations, such that the insurer and not the policyholder should bear the costs of those savings.

The *Fabrique* decision highlights two important principles. The first is that, to deny coverage based on an exclusion, an insurer must show not only that the exclusion applies in a particular case but also that its preferred interpretation of the exclusion is the only reasonable construction. Thus, in the case of Federal's "willful conduct" exclusion, the insurer carried a heavy burden to establish truly culpable conduct beyond intentional nonperformance of a contract, even if such nonperformance is motivated by financial self-interest.

Second, policyholders should not underestimate the value of coverage grants permitting recovery of loss mitigation expenses, such as the "sue and labor" provision at issue in *Fabrique*. Companies may be familiar with standard property insurance provisions regarding "duties in event of loss," which often include duties to provide timely notice and to take reasonable steps to minimize loss. However, the policy may also reimburse the policyholder for all expenses, including litigation expenses, in connection with those loss mitigation efforts, which can be a valuable asset protecting policyholders that vigorously fight to preserve their rights in the event of a loss.

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