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The Executive Summary

Developments Affecting Professional Liability Insurers

Declaratory Action to Determine Coverage Before Litigation of Underlying Action Is Not Ripe

A federal bankruptcy court in New Jersey has dismissed a chapter 11 debtor's declaratory judgment action against its D&O insurer seeking a determination whether the policy afforded coverage, holding that the lawsuit was not ripe because no concrete facts regarding liability had been established in the underlying action. *In re Grand Court Lifestyles, Inc.*, 2004 WL 965890 (Bankr. D.N.J. Mar. 24, 2004).

The insurer issued a D&O policy to a company that acquired, managed and sold senior living communities. The company eventually filed for chapter 11 bankruptcy protection. During the pendency of the bankruptcy, the committee of unsecured creditors (the Committee) filed suit against the directors and officers of the company for allegedly overstating property values. The insurer agreed to advance defense costs subject to a reservation of rights.

The confirmed bankruptcy plan enjoined litigation against the directors and officers unless "the actions and the officers and directors are covered by the [company's] Directors and Officers Liability Insurance or similar insurance policies which coverage actually defends, holds harmless and completely protects the affected [directors and officers] from any and all costs and liability." The company filed a declaratory judgment against the insurer, arguing that it was necessary to determine whether coverage existed as a predicate to the Committee continuing its action against the directors and officers.

The bankruptcy court granted the insurer's motion to dismiss on ripeness grounds. The court initially outlined

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Officer Entitled to Coverage under D&O Policy When Sued as Shareholder

A Massachusetts federal district court, applying Massachusetts law, has held that the president, CEO and majority shareholder of a company insured under a D&O policy was entitled to coverage for a lawsuit that formally named him as a defendant, only in his capacity as a shareholder, on the grounds that a review of the complaint revealed that he was also sued in an insured capacity as a director and officer. *D'Amelio v. Fed. Ins. Co.*, 2004 WL 937328 (D. Mass. Apr. 28, 2004).

The plaintiff in the coverage litigation was the president, CEO and majority shareholder of a sealant and adhesives company. Effective September 17, 1998, the sealant company entered into a stock purchase and sale agreement pursuant to which it sold all of its stock to a third party. As part of the sale, the sealant company made a series of representations and warranties. The sealant company also entered into an escrow agreement whereby $4 million of the $130 million purchase price was paid into an escrow account to guarantee the representations and warranties

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In This Issue

Sixth Circuit Holds Public Officials Policy Affords Entity Coverage

The United States Court of Appeals for the Sixth Circuit, applying Ohio law, has held that a public officials liability policy issued to a port authority afforded coverage to both the port authority and its officials and employees. *Toledo-Lucas County Port Auth. v. AXA Marine & Aviation Ins., Ltd.*, 2004 WL 963517 (6th Cir. May 6, 2004). In addition, the court held that the public officials liability coverage was not conditioned upon a formal claim or demand being made against an individual official or employee.

A port authority purchased a blended "Ports Liability Policy" that provided coverage for various liabilities. Among other things, the insuring agreement of the primary policy provided that the insurer would "pay on behalf of the Assured" damages for liability imposed on the Assured "on account of…Public Officials Liability." "Public Officials Liability" was defined as "any act or alleged act…by an officer and/or…employee…in the discharge of his/her duties as such and claimed against him/her solely by reason of his/her capacity as such." The policy defined "Assured" to include "(a) The Named Assured and/or subsidiary, associated, affiliated companies or owned and controlled companies, their duly elected and appointed officials…officers [and] employees" as well as "(b) any officer, director…or employee of the Named Assured, while acting in his capacity as such."

The court also reasoned that it would be "hard to imagine" that the port authority would have purchased public officials liability coverage for its employees but not itself, given that "state law generally immunizes governmental employees acting within the scope of their employment."

Between 1993 and 1998, the port authority and its employees were named as defendants in several lawsuits arising out of noise created by an air carrier's flights into and out of a local airport operated by the port authority. Some of these suits alleged that the port authority's employees, while acting at the direction of the port authority, had "committed fraud and other wrongful acts" in enticing the air carrier to establish a hub at the airport.

By 1996, all counts alleged against the port authority's employees had been dismissed, leaving only allegations against the port authority itself, which ultimately settled the litigation in 1999 for $4.6 million. The primary and excess insurers declined to pay for the settlement or any of the attorneys' fees incurred by the port authority after the individual employees had been dismissed from the litigation on the grounds that the policy did not afford coverage for a claim asserted against only the port authority. Coverage litigation ensued.

The Sixth Circuit disagreed with the insurers and held that "the pertinent rules of [Ohio] statutory construction…[and] common sense" lead to the conclusion that the public officials liability provision of the primary policy afforded coverage for both the port authority and its employees. First, the court noted that the policy's insuring agreement stated that it covered "any 'Assured' who has to pay damages on account of Public Officials Liability," and "Assured" was defined to include the port authority. The insurers argued that the inclusion of "and/or" in clause (a) of the policy's definition of "Assured" meant that the term had different meanings for different coverage parts of the policy. In the context of the public officials liability coverage part, the insurers contended that the term "public officials liability" included only the port authority's officers and employees. According to the court, however, this argument ignored that fact that the port authority was identified as an assured "without limitation" in "more specific" portions of the policy including the certificate of insurance and the first page.

In addition, the court reasoned that clause (b) in the definition of "Assured" was to be read conjunctively with clause (a), meaning that both the port authority (under clause (a)) and its employees (under clause(b)) were to be considered "Assureds." Although there were no conjunctions or disjunctions between clauses (a) and (b), the court explained that the policy's use of the term

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Court Narrowly Interprets Breach of Contract and Prior or Pending Litigation Exclusions

The United States District Court for the Southern District of California, applying California law, has held that the breach of contract and prior or pending litigation exclusions in a non-profit professional liability policy should be interpreted narrowly in light of the broad coverage grants in the policy. *Church Mut. Ins. Co. v. U.S. Liab. Ins. Co.*, (S.D. Cal. Apr. 23, 2004).

The first insurer issued a general liability policy to a church, and the second insurer issued a non-profit professional liability policy to the church. The professional liability policy provided coverage for "Wrongful Acts," which was defined as "any actual or alleged act, error, omission, misstatement, misleading statement, neglect or breach of duties." The professional liability policy also contained a breach of contract exclusion, which stated "The Company shall not be liable to make payment for Loss or Defense Costs in connection with any Claim made against any Insured arising out of, directly or indirectly resulting from or in consequence of, or in any way involving any actual or alleged breach of contract." In addition, the professional liability policy contained an exclusion barring coverage for "any pending or prior litigation, administrative or regulatory proceeding, claim demand, arbitration, decree or judgment of which an Insured has written notice before the inception date of this Policy."

The underlying suit was brought against the church by a contractor alleging, among other things, breach of contract and two counts of fraud (intentional misrepresentation and concealment and negligent misrepresentation). After the professional liability insurer disclaimed coverage, the general liability carrier agreed to provide a defense and ultimately settled the underlying lawsuit by paying under its policy. The general liability insurer then sued the professional liability carrier, seeking reimbursement for defense and indemnity payments made on behalf of the church on the grounds that the second insurer breached its duty to defend as to the fraud counts in the underlying action. The general liability insurer conceded that coverage was unavailable for the breach of contract count.

The district court first rejected the professional liability insurer's contention that the breach of contract exclusion, when read in conjunction with its broad prefatory language, barred coverage for the underlying fraud counts. The court held that this paragraph applied only to breach of contract claims. The court rejected the insurer's argument that the prefatory phrase "in any way involving" barred coverage for the fraud allegations because the fraud was in connection with a contract, reasoning that this language conflicted with the broad grant of coverage for "Wrongful Acts" in the policy. The court opined that this difference in language created ambiguity, and the language should be construed against the insurer. The court also asserted that the broad interpretation of the breach of contract exclusion urged by the insurer would "eviscerate" coverage and frustrate the reasonable expectations of the church.

The court also held that the prior or pending litigation exclusion did not unambiguously preclude coverage for the underlying action even though the underlying lawsuit included a cause of action to enforce a mechanic's lien that had been recorded prior to the inception of the policy. The court reasoned, as it did in its breach of contract analysis, that the prefatory language in the exclusions section of the policy was inconsistent with the broad grant of coverage in the definition of "Wrongful Acts." Thus, while the breach of contract exclusion barred coverage for the cause of action to enforce the lien, it did not preclude coverage for the fraud allegation. The court also reasoned that a mechanic's lien filed against the church prior to the inception date of the policy was not sufficient to trigger application of the prior or pending litigation exclusion because "the gravamen of [the underlying plaintiff's] claims against [the church] is fraud, rather than failure to pay for construction work." ■

Court: D&O Policy Covers Constructive Discharge Claim Premised on Existence of Employment Contract

In an unreported decision, the United States District Court for the Eastern District of Pennsylvania, applying New Jersey law, has held that an insurer must advance defense costs under a D&O policy for a lawsuit alleging breach of the duty of good faith and fair dealing and constructive discharge, even though those counts were necessarily dependent on the existence of an employment contract and the policy excluded coverage for breach of contact. *Applied Tech Prods. v. Select Ins. Co.*, 2004 WL 945149 (E.D. Pa. April 28, 2004).

The insurer issued a D&O policy that provided coverage for employment claims to the insured company. The policy defined "Employment Claim" to include a claim by an employee for a "Wrongful Employment Practice," which was defined to include, among other things: "(1) wrongful demotion, dismissal, discharge or termination…of employment" and "(14) breach of an implied contract requirement relating to Wrongful Employment Practices as defined herein." The policy excluded coverage for "any Claim for any actual or alleged breach of an express written or oral contract or agreement; however, this exclusion shall not apply…to an Employment Claim if such liability would have attached to the Insured Company in the absence of the express contract in question."

Two of the company's former employees filed suits against the company. Both suits alleged breach of contract, breach of the duty of good faith and fair dealing and constructive discharge. After the insurer denied coverage based on the breach of contract exclusion in the policy, the company filed suit, seeking a declaration that it was entitled to coverage under the policy.

The district court agreed that the breach of contract exclusion barred coverage for the breach of contract counts in the complaints. However, the court held that the policy afforded coverage for the counts alleging breach of the duty of good faith and fair dealing and constructive discharge. The court agreed with the insurer's argument that under New Jersey employment law these two counts could not exist "in the absence" of an employment agreement. However, it explained that the insurer "overlooks the fact that its own policy covers wrongful Employment Practices" and any reasonable Insured reading the Policy would believe [that these two claims are] covered under the Policy." Thus, according to the court:

> The breach of contract exclusion will not apply to Employment Claims if such liability would have attached to the Insured Company in the absence of an express contract. Rather than narrow the application of the exclusion, defendant's interpretation of the "absence of an express contract" language actually expands the exclusion contrary to its plain meaning. ■

Court Certifies Whether Insurer Can Deny Coverage for Claims Made Hours after Policy Expired

A United States District Court in New Hampshire has certified two questions to the New Hampshire Supreme Court relating to a policyholder's compliance with the notice provision in its claims-made liability policy, including whether an insurer must show prejudice to deny coverage for late notice. *Catholic Med. Ctr. v. Exec. Risk Indem., Inc.*, 2004 WL 957952 (D.N.H. May 4, 2004).

The insurer issued a claims-made policy to a medical organization. On the last day of the policy period, which expired at midnight, the medical organization sent by overnight mail to the insurer seven notices of potential claims. The insurer received the materials at 9:03 am the next day. The insurer denied coverage since it did not receive notice until nine hours after the policy expired.

Because the case presented "unresolved questions of New Hampshire law," the district court certified the following questions to the New Hampshire Supreme Court:

(1) Does an insured comply with a provision in a claims-made liability insurance policy requiring the insured to give written notice of acts that may result in future claims before the policy expires if the insured sends written notice via Federal Express while the policy is in effect but the notice is not received until after the policy expires?

(2) If the answer to question one is no, is the insured nonetheless entitled to coverage if the insured substantially complies with the notice requirement and the insurer does not suffer prejudice as a result of the late notice? ■

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Declaratory Action

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three principles to be considered in determining ripeness in a declaratory judgment action:

(i) The adversity of the interest of the parties,

(ii) The conclusiveness of the judicial judgment and

(iii) The practical help, or utility, of the judgment.

Applying these principles, the court first determined that the insurer and the company did not currently possess adverse interests because, while there was a possibility that a coverage dispute might arise based on certain exclusions in the policy, the probability was not yet real or substantial. The court explained that "adversity will only exist if the litigation of the [Underlying] Action results in findings about the Directors and Officers to which the D&O Policy exclusions might apply." Therefore, adversity could not be established because at this stage "it is simply not possible to know what facts will be established regarding [the directors and officers conduct]." The court also rejected the company's contention that a determination regarding coverage was necessary in order to comply with the confirmed bankruptcy plan. The court reasoned that because the insurer was advancing defense costs consistent with its contractual obligation, any judgment regarding coverage at this point would be at odds with the insurance contract.

With respect to the second factor, the court stated that "there are simply no concrete facts from which this Court can determined that [the insurer] is obligated to indemnify [the company] or the Directors and Officers." Finally, as to any utility the declaratory judgment action might provide, the court held that "[t]his criteria plainly cannot be met because it[] is presently sheer speculation whether any liability will be found which will give rise to a covered liability." ■

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Officer Entitled to Coverage

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and to fund an earn-out provision securing the sealant company's obligation to meet certain financial targets.

Also effective September 17, 1998, the sealant company purchased a representations and warranties (R&W) policy and a D&O policy. The R&W policy was excess to the D&O policy. The D&O policy defined "Wrongful Act" as "any error, misstatement, misleading statement, act, omission, neglect or breach of duty committed, attempted or allegedly committed or attempted, by an Insured Person, individually or otherwise, in his Insured Capacity, or any other matter claimed against him solely by reason of his serving in such Insured Capacity." It defined "Loss" as "the total amount which any Insured Person becomes legally obligated to pay on account of each Claim…including, but not limited to, damages, judgments, settlements, costs, and Defense Costs."

Following execution of the stock purchase and sale agreement, the purchaser demanded the escrow funds, alleging that the shareholders of the sealant company breached representations made in the agreement. The purchaser and shareholders became embroiled in litigation, and eventually reached a settlement pursuant to which the shareholders paid $5.7 million in cash to the purchaser and released to the purchaser the entire amount in the escrow account, which totaled $4.7 million with interest. The former president of the sealant company then filed suit against the insurer under both policies, seeking indemnification for the settlement and the cost of the defense.

The insurer argued that the president was not entitled to coverage because the purchaser sued him in an uninsured capacity as a shareholder, not as an officer or director. The court rejected this argument, explaining that the "formal capacity" in which he was sued was not dispositive as to coverage. According to the court:

> The crucial issue is not how a third party (in this case, [the purchaser]) worded its claim, but rather whether [the purchaser's theory of litigation], and the eventual settlement, encompassed allegedly wrongful conduct by [the president] in [his] insured capacity, as defined in the policy. That [the president] acted as a selling shareholder does not defeat coverage.

The court also stated that the complaint by the purchaser contained numerous allegations against the president in his capacity as a director and officer of the company.

The insurer also argued that it had no obligation to fund the payment from the escrow account because that amount did not constitute "loss" under the policy since the company had failed to meet the financial targets necessary to avoid relinquishing the escrow funds. The court noted that although the insureds forfeited their contingent rights to the escrow account as part of the settlement with the purchaser, those contingent rights might have had no value since the earnings targets required to trigger return of the escrow had apparently not been met. However, since the court noted that there was a dispute as to whether the financial targets had in fact been met, it denied the president's motion for summary judgment. ■

Sixth Circuit

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"include" suggested that the clauses should be read conjunctively. The court also reasoned that it would be "hard to imagine" that the port authority would have purchased public officials liability coverage for its employees but not itself, given that "state law generally immunizes governmental employees acting within the scope of their employment."

Finally, the court held that coverage for public officials liability was not conditioned upon a formal claim being made against an individual employee, as opposed to the port authority. The insurers argued that the phrase "claimed against him/her solely by reason of his/her capacity" in the definition of "Public Officials Liability" required that result. The court reasoned that the meaning of the term "claim" was ambiguous in the policy as it was not clear whether it meant "'to demand, ask for, or take as one's own,'" suggesting the need for a formal demand against an employee, or "assert or maintain," suggesting that any allegation of an employee's wrongdoing in a complaint against the port authority would suffice. The court explained that "[w]ere the point of this language" relied upon by the insurers "to exclude coverage when a plaintiff decides to sue the Port Authority for its employee's wrongdoing, one would not expect such a significant limitation on coverage to be tucked away in a phrase addressing the capacity in which the employee acts." ■

Other Decisions of Note

Connecticut Has Jurisdiction over Out-of-State Corporation

In an unreported decision, the United States District Court for the District of Connecticut has held that it has personal jurisdiction over a Pennsylvania corporation, sued by a Connecticut insurer for breach of contract, because the underwriting, receipt of premiums and claim-handling were performed in Connecticut. *Gulf Underwriters Ins. Co. v. The Hurd Ins. Agency, Inc.*, 2004 WL 1084718 (D. Conn. May 11, 2004). However, the court held that it lacked personal jurisdiction over the CEO of the corporation since the count against him was for tortious conduct based on misrepresentations in the application process and there was no evidence that he had committed the alleged tort in Connecticut. The court explained that even if the application contained false misrepresentations, the evidence reflected that (i) the application was first sent to the insurer's subsidiary in Florida and (ii) even if it had been sent to Connecticut, it was sent by the insurance broker, not the CEO. ■

Bankruptcy Removal Provision Trumps Securities Act Anti-Removal Provision

The United States Court of Appeals for the Second Circuit has held that state court securities actions that would be non-removable under the anti-removal provision of the Securities Act of 1933 may nonetheless be removed if they fall within the provision of the Bankruptcy Code that confers federal jurisdiction over all claims "related to" a bankruptcy case. *Cal. Pub. Employee's Retirement Sys. v. Worldcom, Inc.*, 2004 WL 1048203 (2d Cir. May 11, 2004). Various state and private pension funds brought securities fraud actions in state courts alleging violations of the Securities Act of 1933. Section 22(a) of the Securities Act of 1933 precludes removal of such cases. The defendants sought to remove the cases pursuant to 28 U.S.C. § 1452(a), which authorizes removal of actions "related to" a bankruptcy. The Second Circuit held that removal is proper, reasoning that allowing the anti-removal provision of the Securities Act to trump the removal provision of the Bankruptcy Code would "interfere with the operation of the Bankruptcy Code, particularly in large chapter 11 cases." ■

Insurer Breached Duty to Defend by Failing to Finalize Defense Counsel Arrangements

In an unreported decision, the United States Court of Appeals for the Third Circuit, applying Pennsylvania law, has held that an insurer breached its duty to defend under a policy it issued to a church by failing to provide a defense to the church for five months after the underlying complaint was filed because of disagreements over retaining defense counsel. *Rector, Wardens & Vestrymen of St. Peter's Church in the City of Phila. v. Am. Nat'l Fire Ins. Co.*, 2004 WL 1012496 (3d Cir. May 6, 2004). The insurer acknowledged its duty to defend less than a month after the underlying complaint was filed; however, the insurer, the policyholder and a series of proposed defense counsel failed to agree on terms for representation and thus no defense counsel was retained for five months. Although the insurer proposed to engage five different firms during this period, four of them had conflicts or lacked the requisite experience, and the fifth refused to provide representation at the rate cap of $130 per hour for partners and $115 per hour for associates that the insurer demanded. The court reasoned that the duty to defend requires the insurer to retain counsel "able and willing" to defend the underlying litigation and that the failure to do so for five months was a material breach of that duty. ■

Under Alabama Law, Insured Must Be Joined in Lawsuit by Judgment Creditor

The Supreme Court of Alabama has held that when a judgment creditor brings a lawsuit against an insurance carrier, under Alabama Code § 27-23-2, to satisfy a judgment against a policyholder, the judgment creditor must join the policyholder. *Chicago Title Ins. Co. v. Am. Guar. & Liab. Ins. Co.*, 2004 WL 918053 (Ala. 2004). The judgment creditor had obtained a judgment against the policyholder title insurance company but had not joined the title insurance company in its lawsuit against the company's insurer to collect on the policy proceeds. When the title insurance company sought to intervene in the lawsuit, its insurer opposed the intervention on the grounds that the judgment creditor adequately represented the interests of the company. Although the insurer prevailed on its summary judgment motion, the court reversed and remanded the decision based on the failure to join the judgment creditor in the suit. ■

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