

Insurer Relying on Insured v. Insured Exclusion Breached Duty to Defend and Estopped from Denying Coverage on Other Grounds

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Applying Wisconsin law, a federal district court has held that an insurer's refusal to defend its insureds against counterclaims by the insured entity's former COO based on the insured v. insured exclusion was improper and, as a result, the insurer was estopped from denying coverage based on a prior knowledge exclusion after judgment was entered against the insureds at trial. *Link Snacks, Inc. v. Fed. Ins. Co.*, 2009 WL 3380383 (W.D. Wis. Oct. 20, 2009).

The underlying lawsuit arose out of a dispute over control of the insured entity, a family-owned snack food company, after the COO sought to replace his father as CEO. In May 2005, the CEO, along with other officers of the company, made a proposal to buy out his son's interest in the business and terminate his employment. Three months later, the parties signed a "departure memorandum" providing that the son would be terminated as COO of the company and establishing a "negotiation period" during which the parties were to work out an agreement regarding his ownership interest. By September 2005, however, negotiations broke down, and the company and certain of its officers filed suit against the son, seeking a declaration as to his ownership interest and asserting a claim for breach of fiduciary duty. The son answered the complaint in November 2005 and, alleging that the plaintiffs had "schemed to drive him out and raid his interest in the [company]," asserted counterclaims for misrepresentation, breach of fiduciary duty and defamation.

The insureds tendered the defense of the counterclaims to their D&O insurer, which denied coverage based on the exclusion in its policy for claims brought against the company and its executives by any past or present executives of the company. The insurer, accordingly, did not provide a defense to the insureds, nor did the insurer bring an action for a declaration to ascertain its obligations under the policy.

After the insureds lost at trial and judgment was entered against them on the counterclaims, the insureds brought suit against the insurer for breach of contract. The court granted summary judgment in favor of the insureds, concluding that the exception to the insured v. insured exclusion for "D&O Claim[s] brought or maintained by an [officer] for the actual or alleged wrongful termination of such [officer]" applied. In reaching this conclusion, the court rejected the insurer's argument that the exception was limited to claims for the tort of "wrongful discharge" under Wisconsin law. The court noted that the policy did not define the term "wrongful

termination" and that, in any event, the legal theory asserted was not determinative of the duty to defend. Rather, according to the court, the duty was triggered by allegations stating a claim that was at least arguably covered under the policy. In this regard, the court pointed out that the son's counterclaim for breach of fiduciary duty was "clearly premised on his contention that he was wrongfully terminated."

The court also denied the insurer's cross motion for summary judgment, which raised for the first time the argument that coverage was barred by the prior knowledge exclusion set forth in the application for the policy that was submitted to the insurer on June 9, 2005. This exclusion followed the company's representation that no proposed insured was aware of any fact, circumstance or situation that they had "reason to suppose might give rise to any claim that would fall within the scope of [the] proposed coverage," and stated that the policy would not provide coverage for any claim arising from such fact, circumstance or situation. As an initial matter, the court held that the insurer, having breached its duty to defend, was estopped from disputing coverage on this ground. In doing so, the court pointed out that "Wisconsin law is clear [that] [w]hen an insurer wrongfully refuses to defend on the grounds that a claim against its insured is not within the coverage of the policy, the insurer cannot later contest coverage, but is liable to the insured."

The court further held that, even if this were not the case, the exclusion in the application was not triggered by the insured's knowledge of the dispute with the son over control of the company and the proposed buy-out of the son's interest in May 2005. According to the court, the issue was whether "[the insureds] were aware of any situation which they had reason to suppose might give rise to a covered claim," and the insurer, irrespective of whether an objective or subjective test were applied, had "failed to show that [the son's] allegations of wrongful termination were reasonably foreseeable in June 2005." The court pointed out that there was evidence that by June 2005, the son had threatened to leave the company and the insureds had suggested that he do so, but no evidence that the insureds had a "basis to believe" at that time that the son was of the view that he was being forced out of his job.