NEWSLETTER

Primary Insurer and D&Os of Insured Not Required Parties for Rescission Claim by Excess Insurer

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A federal court in New York has held that a rescission claim by an excess insurer did not require the joinder of the underlying primary insurer and several directors and officers of the named insured. *Fed. Ins. Co. v. SafeNet, Inc.*, 2010 WL 5187699 (S.D.N .Y . Dec. 7, 2010). The court also held that the coverage action was ripe for adjudication despite the fact that the primary insurance had not yet been exhausted.

During the relevant policy periods of March 2005 to March 2006 and March 2006 to March 2007, the insured information security company maintained primary and first-layer excess executive and organization liability insurance. The excess policies generally followed form to the underlying primary policy and provided specified coverage to the company's executives for losses for which the company did not provide indemnification. The excess policies also provided specified coverage to the company for claims against its executives for which the company did provide indemnification, as well as for losses arising from securities claims against the company. Under the terms of the excess policies, the insured agreed that the insurer relied on the accuracy and completeness of the statements and representations contained in the application for coverage, which expressly included the company's written application as well as all documents it filed with the Securities and Exchange Commission (SEC) prior to the effective date of the policies. Each excess policy further provided that, in the event those statements and representations were not accurate and complete, the policy was void as to any insured who knew as of the inception date of the policy of the facts that were not accurately and completely disclosed and as to any insured to whom such knowledge is imputed. The knowledge of any CEO and CFO of the company was imputed to all insureds

Beginning in 2006, the company was the subject of multiple legal actions relating to stock options back dating. In August 2006, company shareholders filed a class action securities lawsuit, and after four years of litigation, the parties filed a motion for preliminary approval of a $25 million settlement. In July 2007, the United States Attorney's Office for the Southern District of New York filed a criminal complaint for fraud against the company's CFO. In 2008, the CFO pleaded guilty to securities fraud and admitted that she caused the company to file materially false and misleading financial results from 2000 through mid-2006. Shortly after the commencement of the criminal action, the SEC filed a civil enforcement action against the CFO based on the same conduct. The CFO consented to judgment against her in the enforcement action and agreed to pay certain civil penalties.

After the criminal and SEC enforcement actions had been resolved but while the shareholder class action was still pending, the excess insurer filed suit seeking rescission of the excess policies based on the admittedly false information in the company's SEC filings. The excess insurer initially named as defendants the company, its CFO and CEO, as well as eight other directors and officers. The excess insurer later voluntarily dismissed the eight other directors and officers, and the remaining insureds moved to dismiss the complaint on two separate grounds.

First, the insureds argued that dismissal was required because the other directors and officers as well as the primary insurer were necessary parties to the action and their presence would destroy diversity for purposes of federal court jurisdiction. The court disagreed, concluding that these absent parties were not indispensible under Rule 19 of the Federal Rules of Civil Procedure because: (1) their presence was not necessary to resolve any issues related to the interpretation or viability of the excess policies; (2) the absent parties had not asserted an interest in participating in the instant action; (3) the company failed to demonstrate how the interests of the absent parties would not be adequately served by the litigants in the dispute; and (4) the company failed to demonstrate that the existing parties would be subject to multiple or inconsistent obligations by failing to join the absent parties. The court also rejected the insureds' reliance on cases from other jurisdictions in which the courts had held that a primary insurer was a necessary party to an excess coverage dispute. The court noted that in those cases, unlike the situation here, the issue was the apportionment of liability among the primary and excess insurers, and the need for the presence of both insurers was "logical."

The insureds also argued that the case should be dismissed on ripeness grounds because as of the date of the filing, the primary insurer had not paid out its full $10 million limit of liability. In this regard, the company further pointed out that it had not yet requested that the primary insurer or the excess insurer fund any portion of the $25 million settlement of the securities class action. The court found this fact to be of no consequence unless the company were affirmatively to represent that it would not seek coverage for the settlement. Moreover, the court concluded that despite the contingent nature of the excess insurer's liability at this point, the fact that the company had agreed to settle the securities class action for an amount that would exhaust both the primary and excess layers of coverage was sufficient to establish the "'practical likelihood' that there will be some type of settlement or judgment against the [excess] insurer" to warrant adjudication of the coverage issues. Accordingly, the court denied the insureds' motion to dismiss.