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NEWSLETTER

Insured Entity's Purported Derivative Claim Against Former Officers Triggers Insured vs. Insured Exclusion

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The United States District Court for the Southern District of New York, applying New York law, has granted an insurer's motion to dismiss an insured's action seeking coverage under a directors and officers policy, holding that the policy's insured vs. insured exclusion barred coverage for an insured entity's claim against its former officers. *Greenman- Pedersen, Inc. v. Travelers Cas. & Surety Co.*, No. 10 Civ. 2777 (S.D.N.Y. Aug. 10, 2011). In so holding, the court rejected the insured's argument that its claim against the former officers was a derivative claim falling within an exception to that exclusion

A wholly-owned subsidiary of the insured entity acquired another company in 2006 in an asset purchase agreement, pursuant to which certain officers of the acquired company became officers of the insured subsidiary. In 2008, the insured discovered that the acquired company, as well as its former officers, made material misrepresentations of fact and failed to disclose certain material facts about the financial performance of the acquired company. The insured entity subsequently sued the acquired company and the individual officers who were then employed by its own subsidiary. In 2009, the insured entity made a demand upon its insurer for losses sustained as a result of the alleged wrongful acts of the acquired company's officers, who were then insureds under its own policy.

According to the insured entity's series of letters to its carrier setting forth its claim for coverage: (1) both the insured entity and the acquiring subsidiary were insureds; (2) the former officers were likewise insureds; (3) those officers' conduct was a breach of their duties to the acquiring subsidiary and therefore were "wrongful acts" as defined by the policy implicating coverage. The insured entity further asserted that, because it was the sole shareholder of the acquiring subsidiary, its claim against the individuals was a "Security Holder Derivative Claim," and thus did not fall within the policy's insured vs. insured exclusion, which provided, in relevant part, that coverage was excluded for "any Claim . . . by or on behalf of, or in the name or right of, any Insured; provided that this exclusion shall not apply to . . . any Security Holder Derivative Claim or Security Holder Derivative Demand." After the insurer denied coverage, the insured brought a declaratory judgment action seeking to establish coverage, and the insurer filed a motion to dismiss.

The court began its analysis by noting that the insured entity was attempting "to convert its [D&O policy] into a policy that provides first-party coverage for what amounts to business losses." It then determined that the insured's letters seeking coverage revealed that there was not any actual derivative claim pending against the individual officers - rather, the letters simply constituted a demand from the insured that the insurer pay its limits as a result of the identified conduct. Moreover, the court characterized the argument that the insured's demand was a derivative claim as "nonsense," noting that the hallmark of a derivative action was a shareholder seeking to compel the corporation to take action against a third party because of the corporation's failure to do so, and, in this case, the insured entity had sued the former officers prior to making its demand on the carrier. According to the court, "[t]here is no logical reason for [the insured entity] or any shareholder to make a demand that [the acquiring subsidiary] file an additional action . . . when [the acquiring subsidiary] was already pursuing litigation against them at the time [the claim letters were sent], except as an artifice to implicated coverage . . . ." The court therefore concluded that the insured v. insured exclusion applied and granted the insurer's motion to dismiss.