

District Court Finds No Coverage Based on Prior Acts Exclusion

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A federal District Court in Massachusetts has held that the prior acts exclusion in a D&O policy precluded coverage for a complaint alleging misrepresentations in connection with the sale of franchises because the allegations were related wrongful acts to the same or similar misrepresentations made in connection with the sale of franchises by the same insured to the same underlying plaintiffs prior to the policy period. *Gateway Group Advantage, Inc. v. Am. Int'l Specialty Lines Ins. Co.*, 2003 U.S. Dist. Lexis 24178 (D. Mass. Dec. 4, 2003).

On December 18, 1999, an insurer issued a D&O policy to a company that sold franchises to operate kiosks in retail stores. The policy contained a prior acts exclusion, which stated "This policy only provides coverage for Loss arising from Claims which allege Wrongful Acts occurring on or after December 18, 1998 and prior to the end of the Policy Period and otherwise covered by this policy. Loss(es) arising out of the same or Related Wrongful Act(s) shall be deemed to arise from the first such same or Related Wrongful Act." The policy defined "wrongful act" as "any breach of duty, neglect, error, misstatement, misleading statement, omission or act by the Insureds in their respective capacities...[or] by reason of their status as directors, officers, or Employees of the Company." The policy defined "related wrongful acts" as "wrongful acts which are the same, related or continuous, or wrongful acts which arise from a common nucleus of facts. Claims can allege related wrongful acts regardless of whether such Claims involve the same or different claimants, Insureds or legal causes of action."

On December 16, 1998, the underlying plaintiff executed a license agreement to operate an Illinois franchise. In March 1999, the same underlying plaintiff exercised an option to purchase additional franchises in Missouri. The plaintiff operated the Illinois and Missouri franchises until 2000, when the franchisor ceased its operations.

On August 9, 2000, the underlying plaintiff brought suit in Illinois against the franchisor, seeking damages based on the plaintiff's detrimental reliance on misrepresentations related to the Illinois franchise. On February 22, 2002, the underlying plaintiff filed a separate suit in Massachusetts that related only to the Missouri franchise. The Massachusetts suit tracked the allegations made in the earlier suit concerning the Illinois franchise. The insurer denied coverage for the Massachusetts suit on the ground that the acts complained of in the Massachusetts suit were related wrongful acts to the acts alleged in the Illinois suit, which predated the policy period.

The court granted the insurer's motion for summary judgment based on the language of the exclusion. In doing so, the court rejected the company's argument that the allegations in the Illinois suit could not serve as the basis for a related wrongful act because the Illinois suit did not allege negligence and therefore was not a wrongful act. The court noted that the Illinois suit was based on claims of negligent misrepresentation. Further, the court held that the wrongful act language in the policy at issue covered misstatements and other acts that "go beyond mere oversight." Additionally, the court could find no explanation for why the conduct alleged in the Missouri suit constituted a wrongful act while the conduct alleged in the Illinois suit did not, when the allegations in both suits were essentially identical.

The court next held that the acts complained of in the Massachusetts suit involved related wrongful acts to the acts at issue in the Illinois suit. The court reasoned that the insureds could not point to any misrepresentations that were made specifically concerning the Missouri franchise that were not also made concerning the Illinois franchise. Therefore, because the misrepresentations complained of in connection with the Missouri franchise were substantially the same as the misrepresentations complained of in connection with the Illinois franchise, the allegations in both suits were related wrongful acts. Additionally, the court noted that even if the acts complained of in the two suits were not the same, they were related in that the insureds engaged in "a single course of conduct designed to promote investment" and that any and all misrepresentations arose from that course of conduct. The court held that regardless of whether the misrepresentations underlying both suits were the same or related, the result was the same—the policy afforded no coverage because of the prior acts exclusion.

Finally, the court rejected the argument that the insurer had a duty to defend because the defense based on the prior acts exclusion was not apparent from the face of the Massachusetts complaint read in isolation. The court found that the insurer could rely on the allegations made in the Illinois suit when making its decision on whether or not to defend the Massachusetts suit. Relying on the facts presented in the Illinois suit, the court found that the insurer could have reasonably concluded that no aspect of the Massachusetts claims fell within the scope of coverage.

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