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NEWSLETTER

Other Decisions of Note

September 2006

E&O Insurer May Recover Defense Expenses under Supplemental Agreement with Policyholder
The United States Court of Appeals for the Eighth Circuit, applying Texas law, has held that an E&O insurer was entitled to recover defense expenses incurred in the defense of non-covered claims from its policyholder, even though that right was not granted by the relevant policy, where the parties entered into a supplemental agreement granting the insurer that right. *St. Paul Fire & Marine Ins. Co. v. Compaq Computer Corp.*, 2006 WL 2192634 (8th Cir. Aug. 4, 2006).

The insurer issued an E&O policy to the company that gave the insurer the duty and right to defend all claims. A class action was brought against the company, which retained three law firms to defend it without seeking the insurer's consent. The insurer objected to the rates charged by the firms, but offered to pay 50% of the company's defense expenses and permit the company to retain those firms if the company agreed that the insurer could recover any amounts paid for defense expenses later determined not to be covered under the policy. The company did not expressly agree, but continued to retain the three firms and accepted payments from the insurer for 50% of defense expenses.

After a state court ruled that the claims against the company were not covered under the policy, the insurer filed suit seeking recovery of the defense expenses paid to the company. The Eighth Circuit concluded that the company tacitly accepted the insurer's offered terms, creating a supplemental agreement under which the insurer was entitled to recover defense expenses for non-covered claims.

Post-Employment Actions Do Not Fall within Employment Practices Claim Exception to I v. I Exclusion
In an unpublished opinion, the United States District Court for the Northern District of Illinois has held that an I v. I exclusion in a D&O policy, which contained an exception for employment practices claims, barred coverage for a complaint brought against the company by the former COO seeking relief from post-employment restrictions and for post-employment defamation. *LDDG Operating Co. v. Great Am. Ins. Co.*, 2006 WL 2024255 (N.D. Ill. July 12, 2006).

The court reasoned that because he resigned from his employment at the time he filed suit, any connection to his employment was "too indirect and attenuated" to fit within the exception to the I v. I exclusion.

Insurer Entitled to Rescind EPL Policy Where Application Failed to Disclose Prior Claims History

The United States District Court for the Eastern District of California, applying California law, has held that two EPL policies were void *ab initio* because the policyholder failed to disclose in its application two prior lawsuits that contained claims of sexual harassment against the company and its CEO. *Admiral Ins. Co. v. Debber*, 2006 WL 2051037 (E.D. Cal. July 20, 2006).

The company's CEO answered in the negative a question on the 2002 policy application asking whether within the previous five years any former or current employee alleged harassment against the company or its directors, officers or employees. In fact, two sexual harassment lawsuits had been filed against the company and the CEO just over four years prior to signing the application. The insured claimed the lack of disclosure was inadvertent, but the court held that under California law "a material misrepresentation . . . in an insurance application, whether intentional or unintentional, entitles the insurer to rescind the insurance policy *ab initio*."

The court also rejected the insured's argument that the insurer could not rescind the policies because the claim at issue was filed under the subsequent policy and by the time the company applied for that policy the lawsuits were more than five years old. The court concluded that to "allow an insured to conceal two sexual harassment and retaliation lawsuits clearly filed within five years of the original application and then claim upon renewal of the policy that those suits are outside the five year period is, understandably, unsupported in law." The court also held that the insurer was entitled to rely on the application before issuing the policy and was not required to independently verify the policyholder's claims history. Finally, the court held that a delay of nine months between learning of the misrepresentation and filing the instant rescission action was not unreasonable and, in any case, that the policyholder failed to show that it suffered prejudice by the delay.

Former Officer Is Insured Person for Purposes of I v. I Exclusion

The United States District Court for the Northern District of Georgia, applying Georgia law, has held that the I v. I exclusion in a D&O policy bars coverage for a suit by a former officer of the company against current officers of the company. *Greenwich Ins. Co. v. Lecstar Corp.*, 2006 WL 2052375 (N.D. Ga. July 20, 2006).

The policy defines "insured person" as "any past, present or future director or officer, or member of the Board of Managers, of the Company . . . [or] any past, present or future employee of the Company . . . ." The court held that because one of the plaintiffs in the lawsuit was a corporate vice president, who fell within the definition of "officer," that plaintiff was an insured person. In so holding, the court concluded that it was irrelevant that the underlying suit was also brought by a second plaintiff who was not an officer. In addition, it refused to consider whether the suit was collusive because the plain language of the policy did not limit the exclusion in that way.

No Coverage for Wrongful Acts in Uninsured Capacity

The United States Court of Appeals for the Tenth Circuit has held that a D&O policy did not afford coverage where the insured was not sued in his capacity as an officer or manager of the insured organization. *Kite Family Inv. Co. v. Levings*, 2006 WL 1892588 (10th Cir. July 11, 2006).

In the underlying suit, plaintiffs alleged that the founder of two separate companies, one of them being the policyholder company, orchestrated a corporate reorganization whereby the non-insured company contributed its business assets to the insured company under a contribution agreement, with plaintiffs then purchasing an interest in the insured company. Plaintiffs also alleged that the founder, acting on behalf of the non-insured company, caused it to make misrepresentations in the contribution agreement and that, as a result, plaintiffs were damaged. The appellate court agreed with the lower court's determination that "'neither an Insured Organization nor an Insured Person in his capacity as a director, officer, member or manager of an Insured Organization committed the Wrongful Act for which coverage is sought."

Insurer Did Not Succeed in Interest to Coverage under Prior Cancelled Policy

The United States District Court for the District of Arizona, applying Arizona law, has held, at the motion to dismiss stage, that an insurer did not succeed in interest to coverage under a prior policy that was cancelled due to the insolvency of the prior insurer and therefore had no obligation with respect to the tendered lawsuit. *Biltmore Assoc. v. Twin City Fire Ins. Co.*, 2006 WL 2091667 (D. Ariz. July 21, 2006).

The original insurer became insolvent and cancelled its policy with the insured. Following this, the policyholder entered into a new contract with a different insurer. The court stated that it could resolve the issue on a motion to dismiss because the question was "a legal conclusion." The court held that, because neither the insurance policy with the original insurer nor the insurance policy with the subsequent insurer addressed the transaction between the two insurers, "these factual allegations are insufficient to support plaintiff's contention that [the subsequent insurer] is a 'successor in interest' to [the original insurer] under its contract with [the policyholder]. " The court next stated that, because the policy at issue is a "claims-made" policy, and because the claims were first made prior to the current insurer's policy period, the successor's policy did not cover the lawsuit.

"Notice of Termination" Not Required Where Insured Allows Policy to Expire

The United States Court of Appeals for the Eighth Circuit, applying Arkansas law, has held that where a policyholder allowed a professional liability policy to expire, the insurer was under no statutory duty to provide it with a "notice of termination" advising it of the availability of extended reporting endorsements because the purpose of the statute was to "avoid prejudice from an unexpected loss of claims-made coverage." *Design Professionals Ins. Co. v. Chicago Ins. Co.*, 2006 WL 2034440 (8th Cir. July 21, 2006).

In addition, the court held that: (1) the insurer's failure to fully inform the insured about the availability of tail coverage—even if it violated an insurance department rule requiring the disclosure of all benefits, coverages and provisions of a policy to "first-party claimants"—could not form the basis of a breach of contract claim because the rule provided no private right of action to insureds, (2) the insurer was not equitably estopped from denying coverage on the grounds that it had misrepresented the extent of tail coverage available, and (3) the policyholder had "merged" with another entity—for the purposes of applying a policy provision extending coverage for up to 30 days to entities that the named insured merged with or acquired—where the policyholder had combined its operations with the other entity but had not filed articles of merger with the state because the other entity's "functionality ceased to exist" and the lack of a definition of "merger" created an ambiguity in the policy to be construed in favor of coverage.

Court Dismisses Coverage Action on Summary Judgment Based upon Mandatory Arbitration Provision

The United States District Court for the Western District of Texas has dismissed a coverage action brought by the policyholder based upon the insurer's summary judgment motion invoking a mandatory arbitration provision. *Michael Angelo's Gourmet Foods, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 2006 WL 2241225 (W.D. Tex. Aug. 4, 2006). The D&O policy at issue contained a provision calling for a mandatory alternative dispute resolution process. The policy further provided that, after an initial mediation, either party could request binding arbitration within 120 days. In this case, mediation failed and the insurer sought arbitration.

The policyholder argued that the insurer had waived its right to arbitration because it had wrongfully denied coverage. The court rejected this argument because it would require the court to determine whether there was a duty to defend, which would defeat the purpose of the arbitration. The policyholder also argued that, by participating in discovery, the insurer had waived its right to invoke the arbitration clause. The court noted that the insurer had not brought the suit and that any discovery that had taken place was the voluntary release of documents relating to the underlying litigation. The court ruled that the insurer had not actively engaged in the discovery process, and that such a waiver could only occur where the insurer "showered" the policyholder "with interrogatories and discovery requests." Therefore, the court granted the insurer's motion to compel arbitration and dismissed the remainder of the case.

Court Consolidates Securities and "Derivative" Actions under PSLRA and SLUSA

The United States District Court for the Western District of Missouri has granted motions to consolidate three securities actions with four purported tag-along actions styled as "derivative" suits. *In re American Italian Pasta Co. Securities Litig.*, No. 05-0725-CV-W-ODS (W.D. Mo. Dec. 19, 2005).

The court noted that the only issue precluding consolidation of the various suits was "an attempt by some plaintiffs to characterize their claims as 'derivative claims' instead of securities claims." In rejecting this attempt and ordering consolidation, the court reasoned that "[t]he combined effects of the PSLRA and [SLUSA] render the titles and labels ascribed by the parties irrelevant" and that, in any event, examination of the allegations in the purported "derivative" complaints reveals that plaintiffs "seek damages for fraud in connection with the sale of the company's stock under the guise of a claim that certain officers and officials failed to act in the company's best interests." The court thus ordered all seven of the actions consolidated, on the basis that "[a]ll of the cases share both factual and legal issues, and consolidation will streamline matters and prevent needless confusion, expense, and delay."