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NEWSLETTER

Other Decisions of Note

July 2006

Court Bifurcates Declaratory Judgment from Breach of Contract and Bad Faith Claims

A Pennsylvania federal court has bifurcated and stayed discovery on an insured's counterclaims for bad faith and breach of contract against a D&O insurer. *Federal Ins. Co. v. Continental Cas. Co.*, 2006 WL 1344811 (W. D. Pa. May 16, 2006). The court agreed with the plaintiff insurer that proceeding only with respect to the coverage issues was appropriate because those claims "are the *only* claims that involve *all* of the Plaintiffs and *all* of the Defendants and are the only claims that are susceptible to judicial resolution as a matter of law and with little or no discovery necessary."

WV Supreme Court Finds Coverage for Sexual Assault

The West Virginia Supreme Court has concluded that a professional liability policy issued to a state board of education covers civil claims of sexual assault against a teacher. *Bender v. Glendenning, Jr.*, 2006 WL 1312226 (W. Va. May 12, 2006). In doing so, the court determined that the teacher, who had pled guilty to the criminal assault charges, was an insured under the policy, which defined "named insured" to include past, present and future employees of the school board. The court next considered whether the sexual misconduct at issue constituted a "wrongful act," defined by the policy as "any actual or alleged error or misstatement or act or omission or neglect or breach of duty including malfeasance[,] misfeasance, and non-feasance by the insureds in the discharge of their duties with the 'named insured,' individually or collectively, or any other matter claimed against them solely by reason of their being or having been insureds." The court concluded that it did, noting that the plain meaning of the undefined term "malfeasance" was "a wrongful or unlawful act." The court then noted that no policy exclusion was applicable, and thus coverage was available under the policy for the claim arising from the sexual assault.

Dishonest or Fraudulent Acts Exclusion Applies to All Insureds Under Policy

The Supreme Court of Louisiana, construing a dishonest or fraudulent act exclusion in a legal malpractice policy, determined that the exclusion barred coverage for a legal assistant who negligently helped an attorney engage in fraud, and that the attorney's fraudulent conduct could be deemed established as a matter of law under the policy, even though no judgment or settlement had been entered regarding the attorney's actions. *Bonin v. Westport Ins. Corp.*, _So. 2d_, 2006 WL 1343439 (La. May 17, 2006). This was a direct action suit against the malpractice insurer by the claimant, seeking coverage for claims against the insured legal assistant. The insured attorney fraudulently settled the claimant's case and absconded with the settlement monies. The legal assistant served as a witness to the attorney's forged signatures on the

settlement documents.

The court held that the attorney's actions were clearly within the dishonest and fraudulent act exclusion. The court further determined that the exclusion, which applied to dishonest or fraudulent acts by "an insured," applied to claims made on behalf of any insured under the policy and not just the insured who committed the act. The court determined that, because the legal assistant's negligence would not have given rise to a claim but for the fraud of the attorney, negligence arose out of the attorney's fraudulent act and thus was within the scope of the exclusion. Further, with respect to the policy's requirement that the fraudulent act must be "adjudged," the court decided that, while the attorney's actions had never been tried because of his untimely death, the "overwhelming evidence" of the misappropriation, coupled with the plaintiff's acknowledgement thereof, permitted the court to make a judicial determination that the conduct satisfied the exclusion's terms.

Court Grants Summary Judgment for Insurer; No Wrongful Acts After Applicable Retroactive Date

The United States District Court for the Middle District of Florida, applying Florida law, has granted an insurer's motion for summary judgment, holding that the plaintiff attempting to enforce a consent judgment against the insurer had made no showing that the underlying defendant (an investment advisor) committed any wrongful act after she became covered under the policy at issue. *Scardaville v. Illinois Union Ins. Co.*, 2006 WL 1208011 (M.D. Fla. May 4, 2006).

The insurer issued a financial services professional liability insurance policy to a financial planning/investment company. In February 2001, the underlying defendant obtained employment with the policyholder and was added to the policy. The policy contained a retroactive date with respect to "insured representatives" of "the later of May 26, 1998, or his/her first date of continuous contract or employment with" the company. The underlying defendant provided financial advice to plaintiffs between March 1999 and January 2001. During that time the plaintiffs' investments lost significant value. Plaintiffs ultimately sued the underlying defendant, and the action was settled with the defendant agreeing to a consent judgment and assigning her rights against the insurer to the plaintiffs. Based on the underlying defendant's own testimony that her last contact with plaintiffs was in January 2001, and plaintiffs' failure to put forth any evidence to the contrary, the court granted the insurer's motion for summary judgment based on the policy's retroactive date.

Policyholder's Agent Is Not an "Insured" Under D&O Policy

The United States District Court for the Northern District of Georgia, applying Georgia law, has granted an insurer's motion for judgment on the pleadings, holding that the unambiguous definition of "insured" in the D&O policy at issue did not include an agent of the policyholder. *Douglas County Chamber of Commerce, Inc. v. Philadelphia Indem. Ins. Co.*, 2006 WL 1275036 (N.D. Ga. May 8, 2006). The insurer issued a D&O policy to the policyholder. The policy defined "insured" as "the organization and any individual insured." The policy further defined "organization" as the policyholder and any of its subsidiaries and "individual insured" as directors, officers, trustees, employees, volunteer or committee members of the organization and spouses of the directors and officers.

The policyholder and a company that provided human resources, payroll and insurance administrative services to the policyholder were sued by a former employee of the policyholder. The agent provided services to the policyholder under an agreement that required the policyholder to indemnify the agent for liability and expenses arising out of actions brought by the policyholder's employees. The insurer provided a defense in the former employee's suit to the policyholder but refused to defend the agent. Finding the policy definitions of "insured," "organization," and "individual insured" clear and unambiguous and that the agent did not fall within the definition of "organization" or "individual insured," the court held that the agent was not entitled to coverage under the policy. The court also rejected the policyholder's argument that the policy conflicted with Georgia statutory agency law and should thus be amended to conform to the statute. The court reasoned that "the statute and cases cited by [the policyholder] establish the obligation of a principal to an agent" but that "neither the statute nor the cases establish an obligation on the part of an insurer of the principal" since those obligations are established solely by the terms and conditions of the policy.

Interpleading Policy Limits Absolves E&O Insurer of Duty to Defend

A federal district court has held that an E&O insurer is absolved of its duty to defend claims against an insured company where the insurer pays its policy limits into court and interpleads those funds. *Abstract Title & Guaranty Co. v. Chicago Ins. Co.*, 2006 WL 1343860 (S.D. Ind. May 12, 2006). The insurer issued an E&O policy to the company providing that "[t]he limit of liability stated in the Declarations as 'aggregate' is . . . the total limit of the Company's liability under the policy for all Damages and Claims Expenses." When numerous claims were brought against the company alleging damages in excess of the aggregate policy limit, the insurer interpled its policy limits and deposited those funds with the court. The company brought a separate action for breach of contract and bad faith, alleging the insurer breached its obligation to defend the company in the underlying claims. The court granted summary judgment in favor of the insurer, concluding that its duty to defend under the policy terminated when it filed the interpleader action. Noting that the policy also provided that the insurer would not be obligated "to defend, or continue to defend, any suit after the applicable limit of the Company's liability has been exhausted by payment of judgments, settlements, Damages or Claim Expenses," the court held that the insurer fulfilled its obligation to defend the company by depositing its policy limits with the court.

Negligence Claims Trigger Coverage Under E&O Policy Where Alleged Negligence Does Not Arise Out of Underlying Excluded Tort

In an unreported decision, a Michigan intermediate appellate court has held that an E&O insurer must indemnify an insured company for a settlement of two lawsuits alleging negligent supervision, training and misrepresentation, where those claims were not derivative of the underlying torts of others, even though coverage for those underlying torts would be barred by a policy exclusion. *Five Star Real Estate, LLC v. Kemper Casualty Ins. Co.*, 2006 WL 1294238 (Mich. App. May 11, 2006). Plaintiffs in the underlying suit alleged that an employee of the company and another individual committed various wrongful acts, including misappropriation and defalcation, in connection with certain real estate transactions. Plaintiffs alleged numerous counts against the company, including fraud and conversion, but the company settled the underlying suit solely on allegations of negligent supervision, training and misrepresentation. The E&O insurer disclaimed coverage based on an exclusion for claims "based on or arising out of . . . the conversion,

commingling, defalcation, misappropriation or improper use of funds or other property" or "the inability or failure to pay, collect or safeguard funds held for others." The court concluded that the exclusion did not apply because the company's allegedly negligent conduct did not require that the employee and his agent commit any of the underlying wrongful conduct. The court explained that "[w]here acts of negligence are alleged, they are considered to be 'based on and arise out of' the underlying torts of others only when the negligence is not triggered until the underlying tort is committed."

Anti-Assignment Clause in Merger Agreement Does Not Affect D&O Insurer's Subrogation Rights

In an unpublished decision, a federal district court, applying Tennessee and North Carolina law, has held that a D&O insurer is contractually subrogated to the claims of its insured under a merger agreement between the insured company and an acquiring company, where the merger agreement required the acquiring company to defend and indemnify the insured against claims arising out of an existing securities litigation. *Envoy Corp. v. Quintiles Transnational Corp.*, 2006 WL 1288590 (M.D. Tenn. May 10, 2006).

The D&O insurer defended the insured company against securities litigation, subject to a reservation of rights, after the acquiring company refused to defend the insured company for any defense costs in excess of the self-insured retention under the D&O policy. The insurer then brought a breach of contract claim against the acquiring company pursuant to its subrogation rights under the policy. The court rejected the acquiring company's argument that an anti-assignment clause in the merger agreement deprived the insurer of standing to assert a subrogation claim. Noting that subrogation represents a substitution of the party asserting a claim, while an assignment involves the transfer of property rights in a claim, the court concluded that the insurer's subrogation claims were unaffected by the anti-assignment clause. The court also held that the acquiring company's payment of defense expenses up to the amount of the self-insured retention under the D&O policy did not constitute an accord and satisfaction of the insured company's claims under the merger agreement where the acquiring company tendered such payment subject to a reservation of its rights and the evidence could not support a finding that either party understood the payment to represent satisfaction of the insured company's claims.

Suit Seeking Damages from Insurance Agent for Sexual Assault Not Covered Under Professional Services Policy

The United States District Court for the District of Alaska, applying Alaska law, has held that an insurer does not have a duty to defend an insurance agent in a suit alleging sexual assault under a professional services insurance policy that he purchased. *Ivey v. Am. Home Assurance Co.*, 2006 WL 1452686 (D. Alaska May 19, 2006). According to the court, the agent's "actions in violently assaulting [the underlying plaintiff] and damaging her vehicle do not fall under even the most broad definition of 'professional services.'" Although there was a dispute as to whether the insurer had ever received the letter tendering the complaint, to which it had not responded, the court held that it did not matter whether the insurer responded or not because "coverage for conduct not within the policy cannot be forged anew by estoppel." The court also noted that the agent failed to show reasonable reliance because he did not comply with claims reporting procedures and never followed up with the insurer. Finally, the court explained that the agent failed to establish prejudice given that his employer paid for his defense.

Disgorgement of Fees by Attorney Serving As Trustee Does Not Constitute Damages

The United States District Court for the Eastern District of Virginia, applying Virginia law, has held that an order awarding restitution and disgorgement of commissions that the policyholder-attorney received while acting as a trustee did not constitute damages under a lawyers professional liability policy. *Am. Zurich Ins. Co. v. Doherty*, 2006 WL 1391425 (E.D. Va. May 19, 2006). The court held that the "damages awarded [were] restitutionary in nature and thus f[e]ll outside of the damages definition ... in the policy." In so holding, the court rejected the attorney's argument that the damages were covered because they had been characterized as "compensatory." The court explained that "[w]hile the language of the letter opinion does indeed state 'compensatory damages,' the gravamen of the opinion deals with the return of the commissions [the attorney] received from the two business entities but did not report on the annual accounts.'"

Coverage Litigation Over D&O Policy "Not Related" to Bankruptcy Proceeding in Post-Confirmation Stage

In an unpublished opinion, the United States District Court for the Southern District of Texas has remanded a coverage action to state court for lack of subject matter jurisdiction. *Meyer v. Nat'l Union Fire Ins. Co. of Pittsburgh*, 2006 WL 1407469 (S.D. Tex. May 22, 2006). Following the disposition of an adversary proceeding, the insured filed suit against two D&O insurers, alleging that the insurers failed to pay his defense and settlement costs. The insurers removed the case to federal court pursuant to 28 U.S.C. § 1452.

The court granted the insured's motion to remand, rejecting the argument by the insurers that the coverage action was "related to" the bankruptcy proceeding. The court first rejected the insurers' argument that the insurance proceeds are the property of the estate. Second, the court rejected the insurers' assertion that a prior bankruptcy order, limiting the distribution of up to $1 million of insurance policy proceeds on behalf of certain former officers and directors, could be violated by an excess ruling in the present case, as the court emphasized that the insured did not participate in seeking the order nor would the order apply to any damages potentially recovered by the insured in the present case. The court also noted that the bankruptcy proceeding had been in the post-confirmation stage for several years.

Insurer Has Duty to Defend Complaint Containing Facts Supporting Claim for Conversion

In an unpublished opinion, the United States District Court for the Eastern District of California, applying California law, has held that an insurer had a duty to defend a public utility district under a public officials professional liability policy where a complaint against the district contained facts supporting a claim for conversion, which would have been covered, even though the complaint did not contain a cause of action for conversion. *Sierra Foothills Public Utility Dist. v. Clarendon Am. Ins. Co.*, 2006 WL 1350345 (E.D. Cal. May 17, 2006). The court also held that the insured-versus-government entity exclusion was not applicable because materials submitted by the public utility district to the insurer indicated the possibility that the general manager was an independent contractor rather than an employee of the district. The court noted the "well-established" rule in California that the insurer may be required to defend in circumstances where the complaint might be amended to give rise to a liability that would be covered under the policy.