

I v. I and Breach of Contract Exclusions Bar Coverage for Dispute Between LLC Members

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The United States District Court for the Northern District of California, applying California law, has held that a D&O policy afforded no coverage for a suit brought by an ousted member of an LLC against the members who ousted him. *Focal Point LLC v. CNA Ins. Co.*, 2008 WL 2397422 (N.D. Cal. Jun. 10, 2008). The court held that the I v. I exclusion barred coverage for the claims against the individuals. The court further held that no coverage was available under the entity coverage part of the policy as the ousted member did not assert a claim against the LLC and the individual insureds' indemnification demand against the LLC was barred by the policy's breach of contract exclusion.

Four members of the insured private LLC voted to expel another member. The expelled member disputed his ouster, asserting that the other members breached their fiduciary duties to him and the duty of good faith and fair dealing. Specifically, the expelled member asserted that he was not given his fair share of the value of the LLC when he was expelled. The LLC members sought coverage under a policy issued to the LLC, which included both D&O and entity coverage parts. The insurer denied coverage based on the I v. I exclusion and the fact that entity coverage was not implicated because the expelled member's claims were against the four individual members and not the LLC. Later, the individual insureds made an indemnification demand upon the LLC and tendered that claim to the insurer. The insurer again denied coverage.

The D&O coverage part contained an I v. I exclusion for

Any Loss . . . in connection with any Claim made against the Insured Persons . . . by or on behalf of any of the other Insured Persons in any capacity

As the parties did not dispute that the expelled member was an Insured Person, the court held that the I v. I exclusion applied to bar coverage under the D&O coverage part.

The individual insureds argued that the entity coverage part applied because the expelled member's claim was actually against the LLC as well as against the individual insureds. The court pointed out, however, that the expelled member expressly stated that he did not assert a claim against the LLC. Further, the court found

that, regardless of the expelled member's characterization, the claim was against the individual insureds only. As the LLC did not owe fiduciary duties to the expelled member, the court determined that the LLC could not have been sued for violations of those duties. The individual insureds also contended that the entity coverage part applied because it required the insurer to advance defense costs for allegations of a breach of duty by any natural person "for whose Wrongful Act [the insured LLC] is legally responsible." The court determined, however, that "though [the LLC] might have been contractually responsible to defend against allegations of breaches of fiduciary duty committed by its individual members, there is *no legal* responsibility upon [the LLC] for the same."

The individual insureds also argued that the entity coverage part applied because their indemnification claim against the LLC constituted a covered claim under the policy. The court determined, however, that the policy provided no coverage for the indemnification claim because the policy excluded coverage for

Loss . . . in connection with any Claim made against [the LLC] . . . for breach of any written or oral contract or agreement

The court determined that the individual insureds could advance an indemnification claim against the LLC only as a claim for breach of the indemnification provision in the LLC's operating agreement. Thus, the exclusion applied.

The court also noted that public policy supported its conclusion. To transform the expelled member's claim against the individual insureds into a claim by the individual insureds against the LLC, the court determined, would "effectively allow for transformation of every internal director dispute into a claim against the entity that the directors represent." This, the court reasoned, would "in effect, eviscerate the 'insured vs. insured' exception in the D&O coverage part of most insurance policies." Furthermore, the court acknowledged that "[t]he insurance carrier cannot and should not be held liable for contractual obligations the entity places upon itself" as "[t]his would allow the entity to place undue burdens upon itself because it would not be the one that would have to satisfy those burdens."