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NEWSLETTER

Coverage for Securities Claim Brought by Former Director Barred by I v. I Exclusion

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A federal court in Florida has held that there is no D&O insurance coverage for a securities class action brought by a former director based on the insured v. insured exclusion.*Sphinx Int'l, Inc. v. Nat'l Union Fire Ins. Co.*, No. 6:01-CV-1462, 2002 WL 31319742 (M.D. Fla. Sept. 10, 2002). The court held, *inter alia*, that the lack of collusion between the underlying litigants did not foreclose the application of the exclusion.

A former director of the insured entity brought a securities class action against the insured entity and several of its directors. Thereafter, the former director solicited and recruited other shareholders to join in the litigation. The insureds sought coverage for the securities class action under a directors and officers liability policy. The insurer denied coverage based on the I v. I exclusion, which barred coverage for claims against insureds brought:

By or at the behest of the Company, or any affiliate of the company or any Director or Officer, or by any security holder of the Company, whether directly or derivatively, unless such Claim is instigated and continued totally independent of, and totally without the solicitation of, or assistance of, or active participation of, or intervention of any Director or Officer or the Company.

In response, the insureds filed coverage litigation.

The court rejected several arguments of the insureds in holding that the I v. I exclusion barred coverage for the securities class action. First, the insureds claimed that the exclusion did not apply because the former director who initiated the securities litigation was not a "duly" elected or appointed director and thus did not fall within the definition of "Director." Apparently, the former director had only held the position for a short period of time before the insured entity discovered that the former director was subject to a covenant not to compete and had misrepresented his experience and expertise. Defining "duly" as "properly, regularly, and according to law," the insureds maintained that the director was not "duly" appointed because his appointment was not according to law. The court rejected the insureds' construction as constrained and unreasonable, and instead held that a director is "duly" appointed if he is appointed "through regular and proper channels of corporate governance." The court also noted that the insureds had listed the former director as a former director in its applications for insurance. Accordingly, the court found that it was improper for the insureds "to keep the positive benefit under the [policies] of naming [the former director], but now want

to avoid the negative implications of this designation."

The court also rejected the insureds' argument that the insurer must prove collusion to invoke the I v. I exclusion. In so holding, the court adopted in part the reasoning of Judge Posner in*Level 3 Communications, Inc. v. Federal Insurance Co.*, 168 F.3d 956 (7th Cir. 1999). The court observed that, like Judge Posner, it would not replace the contractual language of the I v. I exclusion with the rationale for the I v. I exclusion to create a standard that the exclusion only applies where the underlying action is collusive: "the original rationale underlying a legal or contractual norm does not provide a legal straightjacket." The court, however, did not adopt Judge Posner's holding in *Level 3* that coverage was barred only as to the portion of the settlement that was received by the former director. Noting that, unlike in *Level 3*, the former director initiated the securities litigation in this case, the court found that the I v. I exclusion covers the claims of all the plaintiffs in the securities litigation and not just those of the former director. The court also noted that, unlike the exclusion at issue in *Level 3*, the exclusion in this case barred coverage for any claim made at the instigation of, or with the assistance or participation of, any director or officer. Because the director in this action instigated, assisted and participated in the securities class action, the I v. I exclusion barred coverage for the entire securities class action settlement.

The court also rejected the insureds' contention that in determining coverage for defense expenses, the insurer can only look to the allegations of the underlying complaint. Under this view, the insurer had a duty to advance defense costs because the underlying complaint did not allege that the former director was a former director. This argument was rejected by the court because, unlike the cases on which the insureds relied, the policy in this case did not contain a duty to defend. The court also found that the insureds' argument that they had a reasonable expectation of coverage for the underlying litigation was without merit since Florida had rejected the reasonable expectations doctrine. Lastly, the language of the I v. I exclusion was found unambiguous. The court reasoned that although the insureds may think the application of the exclusion in this case "is unfair or unreasonable," the language of the exclusion was clear when they negotiated the policies and "they could have attempted to negotiate more favorable terms." Moreover, according to the court, the language of the I v. I exclusion does not "swallow up" the remainder of the policy because the exclusion would not apply to shareholder or derivative suits brought without the assistance of a director or officer.

For more information, please contact one of WRF's Professional Liability Attorneys *at 202.719.7130.*