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NEWSLETTER

# I v. I Exclusion Inapplicable to Claims by Officer Who Was Not "Duly Elected"

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The United States District Court for the District of Arizona, applying Arizona law, has held that the insured versus insured exclusion in a D&O policy did not preclude coverage for a claim by a former president of a wholly owned subsidiary who was not a "duly elected" officer of that subsidiary. *Kealy v. Carolina Casualty Ins. Co.*, 2007 WL 158734 (D. Ariz. 2007). The court also held that the insurer had waived the right to invoke the exclusion because the former president was an "employee" as the insurer's reservation of rights letter was based only on the president's status as an officer. Finally, in considering a separate lawsuit brought by another former officer who was also a shareholder, the court held that the exception to the insured versus insured exclusion for claims brought without the assistance of any insured was inapplicable where the officer was affirmatively assisting in the litigation against the insured company.

This action arose from two separate lawsuits brought by employees of the insured company's subsidiaries. The D&O policy contained an insured versus insured exclusion stating that "the insurer shall not be liable to make any payment for Loss in connection with a Claim made against any insured ... by, or on behalf of, or in the right of the Company, or by any of the Directors and Officers." The policy defined "Directors and Officers" as "duly elected or appointed directors and officers of the Company." The two employees of the subsidiaries, which had been acquired by merger with the insured company, sued the company's directors and officers for failing to provide adequate consideration in connection with the mergers. The insurer denied coverage for both lawsuits based on the insured versus insured exclusion.

With respect to the first lawsuit, the insurer denied coverage under the insured versus insured exclusion on grounds that the underlying plaintiff was the president of the post-acquisition subsidiary, relying on an employment agreement that identified him as the subsidiary's president. The insureds contended that the underlying plaintiff was never "duly elected" in that capacity pursuant to the subsidiary's by-laws. The court held that the employment agreement was not sufficient to render the underlying plaintiff a "duly elected or appointed" officer, and that the insured versus insured exclusion did not preclude coverage on that basis.

The court then considered the insurer's alternative argument that an endorsement to the insured versus insured exclusion modified the definition of "Directors and Officers" to include "employees" in the context of securities claims such as the underlying action. The court rejected this argument, stating that the insurer had failed to rely upon the endorsement as a basis to deny coverage in its reservation of rights, and accordingly,

had waived the right to rely on that coverage defense. The court further indicated that this result was consistent with A.R.S. § 20-461(A)(15), which requires insurers to "promptly provide a reasonable explanation of the basis in the insurance policy relative to the facts or applicable law for denial of a claim...."

With respect to the second lawsuit, there was no dispute that the underlying plaintiff was an "officer" as defined by the policy. However, the insureds contended that an exception to the insured versus insured exclusion applied to prevent its application. That exception applied where: (1) the director or officer is also a security holder of the company; and (2) the 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 Insured or the Company." The insureds asserted that the underlying plaintiff. was a security holder in the insured corporation and that his claims were brought independent of any other insured. The court rejected this argument, holding that the exception applied only to "shareholder derivative claims or claims in which directors or officers 'are included in a class of security holder plaintiffs, but they are only included by virtue of their status as shareholders, and they are not actively participating as litigants.'" Because the underlying plaintiff himself "instigated and continued" the lawsuit, the exception was inapplicable and the insured v. insured exclusion barred coverage.