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NEWSLETTER

Derivative Carve-Back To I v. I Exclusion Inapplicable Where Action Brought By Former Officers; Prejudice Unnecessary for Late Notice Denial under Expired Claims-Made Policy

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The United States District Court for the Southern District of New York, applying Texas law, has held that an insured-versus-insured exclusion in a professional liability policy barred coverage for a derivative action where the two lead plaintiffs were the company's former CEO and president of an acquired company. *Julio & Sons, Co. v. Travelers Cas. & Sur. Co. of America*, 2010 WL 520597 (S.D.N.Y. Jan. 9, 2010). The court also determined that coverage under the same policy for a second, unrelated suit was barred due to the insured's failure to provide timely notice of the suit.

The insurer issued a claims-made professional liability insurance policy to a restaurant holding company. The policy's I v. I exclusion barred coverage for any claim brought "by or on behalf of, or in the name or right of, any Insured." The exclusion was subject to a carve-back for derivative actions brought "by or on behalf of, or in the name or right of, the Insured Organization brought by a security holder of the Insured Organization, and brought and maintained independently of, and without the assistance, participation, or intervention of any Insured . . ." With respect to notice of claims, the claims-made policy provided that notice of claims must be provided "as soon as practicable."

In June 2007, shareholders of the restaurant holding company brought a derivative action arising out of the holding company's unprofitable decision to purchase a restaurant. One plaintiff in the derivative action was the former CEO and a former member of the board of directors of the restaurant holding company. The other plaintiff was president of the restaurant purchased by the restaurant holding company as well as a board member. The insurer denied coverage for the derivative action based on the policy's I v. I exclusion. In April 2008, the insured provided the insurer with notice under the same policy of an unrelated suit that was filed in February 2007. The notice was thus provided ten months after the insured first received notice of the lawsuit and seven months after the policy expired. The insurer denied coverage for the vendor's suit based on late notice. The insured company subsequently initiated coverage litigation alleging both denials were wrongful.

The district court held that the policy's I v. I exclusion barred coverage for the derivative suit. In response to the insured's arguments that the carve-back for derivative actions rendered the exclusion inapplicable, the court held that "by implication, the policy exclusion still applies [whenever] an Insured Person . . . participates, assists, or intervenes in a derivative suit" and that, where "shareholders bringing a derivative action on behalf of an Insured Organization are themselves Insureds, the derivative exception is inapplicable." The court also rejected the insured's arguments that this conclusion rendered the carve-back "illusory," noting that it is not atypical for derivative actions to be brought by shareholders who are not insureds.

With respect to the vendor's suit, the court agreed that the policyholder's late notice barred coverage. As an initial matter, the court rejected the restaurant holding company's argument that the insurer waived the policy's conditions when the insurer erroneously denied coverage for a previous suit. The court held that denial of coverage waived the policy's conditions only as to the action for which the insurer previously denied coverage and that the restaurant holding company was not excused from complying with the policy's notice requirement for a separate suit. Since the restaurant holding company provided notice of the vendor suit ten months after the company was served with a copy of the complaint, the court held that notice of the vendor's suit was late as a matter of law. The court then held the insurer was not required to show prejudice because the notice was provided after the claims-made policy expired. While the court acknowledged that some courts applying Texas law have concluded that a showing of prejudice is sometimes necessary under a claims-made policy where the policy had not yet expired at the time the notice was provided, the court emphasized that the claims-made policy in this case expired seven months before the insured notified the insurer. Accordingly, the court determined that no showing of prejudice was required and stated that a ruling otherwise would cause the insurer to "lose the benefits it bargained for in exchange for offering claims-made policies: limiting the maximum tail exposure period and avoiding the increased risks associated with future inflation, the prospect of increasing jury awards, and unanticipated changes in the substantive law."