

Insured v. Insured Exclusion Inapplicable to Derivative Suit Brought by Both Insureds and Non-Insureds

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The United States District Court for the Western District of Texas, applying Texas law, has ruled that a shareholder derivative suit brought on behalf of both insured persons and non-insured persons is not barred from coverage in its entirety by a D&O policy's I v. I exclusion and must be defended by the insurer. *Fed. Ins. Co. v. Infoglide Corp.*, 2006 WL 2050694 (W.D. Tex. July 18, 2006).

The insurer issued a D&O policy to a company. The policy defined "insured persons" to include all "members" of the "Insured Organization." It excluded coverage for derivative suits brought with the "solicitation, assistance or participation of any Insured." Various former officers, directors and other shareholders brought suit against the company and its current officers and directors. The insurer initially denied coverage based on the I v. I exclusion, asserting that the entire suit was brought on behalf of former officers and directors who were insured persons under the policy. Subsequently, the insurer argued that coverage was also barred by the exclusion for derivative suits brought with the participation of any insured. The insurer then commenced a declaratory judgment action to resolve the coverage questions.

The court first considered whether coverage for the suit was barred by the I v. I exclusion, focusing on two cases, *Sphinx International, Inc. v. National Union Fire Insurance Co. of Pittsburgh, Pa.*, 412 F.3d 1224 (11th Cir. 2005), and *Level 3 Communications Inc. v. Federal Insurance Company*, 168 F.3d 956 (7th Cir. 1999). The insurer argued that *Sphinx* dictated that coverage is barred for any suit in which an insured is in the plaintiff class regardless of whether there are non-insureds in the plaintiff class. The court, however, found *Level 3* more persuasive because the policy before it, unlike that in *Sphinx*, contained an allocation clause, and the *Level 3* court determined that such an allocation clause allowed the insurer to allocate coverage for the portion of the suit not brought on behalf of insureds.

In support of the insurer's argument that the I v. I exclusion should nonetheless apply because all of the plaintiffs were "members" of the corporation, pursuant to the amended definition of insured persons, the court concluded that the insurer's reliance on a dictionary definition of "member" was overly broad. The court ruled that such a broad reading would violate principles of insurance policy interpretation and noted that the broad interpretation would eliminate coverage for all derivative suits—even though the policy at issue specifically

carved out coverage for some, but not all, derivative suits. Therefore, the court concluded that the broad interpretation of "member" was unreasonable because it would create illusory coverage.

The court next considered the exclusion for shareholder derivative suits. The court ruled that the exclusion only applied if there were no "direct"—rather than "derivative"—claims at issue. According to Texas law, because the corporation was a Delaware entity, the court looked to Delaware law to determine if any of the causes of action were "direct." The court ruled that at least one of the claims was direct because it alleged that certain shareholders were owed compensation for the dilution of their stock. Accordingly, because the direct claim was subject to coverage, the court ruled that Texas law required that the insurer defend the entire suit.

The insurer also argued that portions of the settlement reached by the insureds were not covered because the policy excluded coverage for loss on account of claims brought by any individual or entity owning more than 10% of the policyholder's stock, and some of the underlying plaintiffs did own more than 10% of the company's stock. However, the court held that there was insufficient evidence on the summary judgment motion to rule whether certain individuals owned in excess of 10% because of factual issues regarding stock ownership or control.

The court then turned to various bad faith arguments advanced by the policyholder. The policyholder claimed that the insurer breached its covenant of good faith and fair dealing in its claims handling process. The court, however, noted that there was no breach of this duty when liability was not "reasonably clear" and that the insurer had a reasonable basis for denying coverage, as Texas law did not clearly address the coverage defenses at issue. The court also rejected the statutory bad faith claims, citing a lack of factual support for the claims and the existence of a reasonable basis for the insurer's coverage position.

With respect to the company's argument that the insurer had violated Texas claims handling requirements by failing to tender a defense or settle the underlying claims, the court noted that the question of whether those guidelines apply to third-party claims was currently pending before the Texas Supreme Court on certification. Accordingly, the court deferred consideration of the issue "in hopes that a definitive answer will be forthcoming from the Texas Supreme Court."