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NEWSLETTER

Court Denies Motion to Dismiss Based on Prior Litigation and Personal Profit Exclusions and Exhaustion

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In an unreported decision, the United States District Court for the Southern District of New York, applying New York law, has held that: (1) the equitable bar on recovering ill-gotten gains applies only to money personally possessed by an insured, (2) a prior and pending litigation exclusion did not necessarily require dismissal of a lawsuit despite the existence of a prior suit with "substantial" overlap, (3) there were sufficient factual disputes to preclude dismissal based on rescission, (4) the personal profit exclusion bars coverage only for those individuals who personally profited, (5) it could be unreasonable to hold that an excess policy did not attach where the primary policy did not exhaust because of that insurer's insolvency and (6) the court could determine whether an insurer's payment of defense costs had been for "reasonable and necessary" costs. *Pereira v. Nat'l. Union Fire Ins. Co.*, 2006 WL 1982789 (S.D.N.Y. July 12, 2006).

The policyholder filed a petition for liquidation under chapter 7. The trustee in bankruptcy brought an action against six current and former officers and directors, alleging that they violated their fiduciary duties. The trustee obtained a sizeable judgment and, in turn, brought this action to recover under the company's D&O policy. Since the primary insurer was insolvent, the trustee sued only the excess insurers.

One of the insurers argued that the claims in the underlying judgment were equitable in nature and were therefore not covered under the policy. The court, however, held that the bar for recovery of equitable judgments applied only to the recovery of monies that were wrongfully held or the restitution of ill-gotten gains. In this case, the decision in the underlying action had found that only one of the officers had personally possessed any of the disputed funds. Thus, the court excluded only the trustee's claims for the portion of the judgment representing the return of monies wrongfully obtained by that officer.

The insurers next argued that coverage was precluded under the prior litigation clause. That provision provided that the insurer shall not be liable if the present claim "ar[o]se [ ] out of, . . . in consequence of, or in any way involv[ed]" the factual circumstances of any action pending when the policy incepted. The insurer argued that the trustee's claims were the same as those asserted in an action pending in Delaware state court at the time the company applied for the policies. The court agreed that the two lawsuits had a "substantial, but not perfect, overlap," but nevertheless concluded that "it could not be said that there are no circumstances under which the Trustee would be able to prevail."

One of the insurers also argued that the policies were void because the company's CFO represented in the application that there were no errors or omissions that could give rise to a claim. The court, however, did not void the policy because it found that there were disputed questions of fact remaining. The court determined that the judge's findings in the underlying action of ongoing breaches of fiduciary duty and excessive compensation were not dispositive of what the CFO knew at the time he signed the application. The court also held that, although the Delaware action was pending at the time the representation was made, the plaintiffs did not specify an amount of damages. Therefore, it was possible that the CFO believed the claims would not reach the excess layers. Finally, the court was unwilling to conclude as a matter of law that the representation was material given the plaintiff's assertion that the litigation must have been disclosed to the insurers who might have "decided to provide coverage despite the existence of this action."

Regarding the personal profit exclusion, the court held that it only precluded coverage for those insureds who personally profited. The exclusion at issue stated that the insurer would not be liable "in connection with a Claim made against an Insured: (a) arising out of . . . the gaining . . . of any profit . . . to which an Insured was not legally entitled." The exclusion also contained a severability provision that the wrongful acts of an insured "shall not be imputed to any other Director or Officer for purposes of determining the applicability of" the exclusion. The insurers argued that the use of the term "*an* Insured" rendered the provision effective against all insureds if it applied to one. The court rejected this argument, noting the existence of a severability provision and finding at the very least that the provision was ambiguous.

One of the insurers argued that its policy was not triggered because the primary policy had not been, and would not be, exhausted because the primary insurer was insolvent. That insurer's policy attached "only after all Underlying Insurance has been exhausted by actual payment of claims or losses thereunder." The court conclude that such an interpretation would impose a "hardship on the insureds, who have already been deprived of a layer of coverage by insolvency, and provide a windfall to the excess insurers." Based on this reasoning, it held that the insurer's interpretation of its exhaustion language was not the only "reasonable" one.

The court also rejected one excess insurer's motion to dismiss on the ground that its $10 million policy limit had been exhausted by the payment of defense costs. The court determined that while the policy limits were inclusive of defense costs, the affidavit establishing the payment of defense costs was not properly before the court on a motion to dismiss. Moreover, the court held that the trustee had standing to object to the reasonableness of the insurer's payment of defense costs, finding that the provision defining defense costs as "reasonable and necessary" could be interpreted to mean those that were objectively reasonable.