

Direct Action Cannot Trigger Derivative Exception to I v. I Exclusion

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The U.S. Court of Appeals for the Eleventh Circuit, applying Alabama law, has ruled that a claim brought as a direct action against a company by one of its former shareholders and officers does not implicate the "securityholder derivative action" exception to the "insured vs. insured" exclusion in a D&O liability policy even if the claim could have been brought derivatively. *Vulcan Engineering Co. v. XL Ins. America*, 2006 WL 2873204 (11th Cir. Oct. 11, 2006).

The D&O policy at issue had an I v. I exclusion with an exception for a "securityholder derivative action," which the policy defined as "any Claim brought on behalf of, or in the name or right of, the Insured Organization by one or more securityholders of the Insured Organization in their capacity as such if such Claim is brought and maintained without the assistance, participation or solicitation of any Executive."

A former shareholder and officer of the insured company brought a direct action against the company and two of its officers. The complaint alleged that the officers had breached their fiduciary duties and had engaged in fraud and suppression of the company's worsening financial condition. The insureds argued that even though the action would normally fall under the I v. I exclusion in the policy, coverage was restored by the "securityholder derivative action" exception to the exclusion. The insureds reasoned that, although the suit was brought as a direct action, the former shareholder "should have brought those claims derivatively" and therefore that the exception should apply.

The court, reading the "plain meaning of the clause," stated that "whether a claim is derivative turns on how that claim is brought, rather than on the injury underlying that claim. How it actually was brought trumps how it might have been brought." The court explained that, because the lower court found "ample evidence" that the claims were part of a direct action, they could not be viewed as derivative for purposes of the exclusion. The court thus held that the "securityholder derivative action" exception did not apply.

The court also considered the insureds' argument that the policy provided coverage because the policy provided that the insurer could not refuse to defend claims simply because they were "groundless, false or fraudulent." The court determined that the policy "does not provide affirmative coverage against groundless claims," as the insured suggested. Rather, the court observed that, while the policy provides that the insurer

cannot refuse to defend a covered claim based on its determination that the claim is without merit, this did not mean coverage was extended to all groundless claims. Because the insurer had correctly determined that there was no coverage for the suit based on the I v. I exclusion, the insured's contention regarding the relative lack of merit of the claim was irrelevant.