

Insured's Claim for Indemnification of Directors and Officers Deemed a First-Party Claim

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The United States District Court for the Southern District of Texas, applying Texas law, has granted the 12(b)(6) motion of several insurers, holding that an insured failed to plead actual loss under the policy or compliance with Texas statutory notice requirements.

In doing so, the court also concluded that the insured's claim for indemnity under a D&O policy was a "first-party claim," which could support a "bad faith" cause of action against its insurers. *Westcott Holdings, Inc. v. Monitor Liab. Managers, Inc.*, 2005 WL 2206196 (S.D. Tex. Sept. 12, 2005).

This action arose from a dispute over an insurer's alleged failure to pay the insured's costs incurred defending two lawsuits filed against the policyholder and its directors and officers. The insured purchased a claims-made D&O policy, which provided coverage for "Wrongful Acts" committed by the insured's directors and officers to the extent that the insured indemnified its directors and officers. The insured filed suit in state court asserting breach of contract, bad faith, unfair settlement practices and deceptive trade practices claims based on the insurers' failure to indemnify the insured for certain defense costs. The insurers removed to federal court, then moved to dismiss under Rule 12(b)(6).

To support their motion, the insurers first cited the insured's failure to plead that it had indemnified its officers and directors and, consequently, to allege a loss under the policy. In response, the insured argued that indemnification is merely a condition precedent to suit, which the insured generally averred, as allowed under Federal Rule of Civil Procedure 9(c).

Despite the insured's asserted compliance with Rule 9(c), the court deemed the pleading insufficient, explaining that the requirement to indemnify directors and officers was not a "condition precedent" to coverage under Texas law but was instead one type of loss covered by the policy. The court observed that, under the express policy terms, the primary insurer agreed to pay losses to the insured for claims made against its directors and officers "to the extent that the Company has indemnified the Directors or Officers" and that the policy clearly anticipates the insured indemnifying its directors and officers as a requirement for establishing any right to payment of "loss" under the policy.

The court likewise rejected the insured's claim that its restated bylaws, which stated that the insured would indemnify its directors and officers "to the fullest extent permitted by the Texas Business Corporations Act upon the request of director or officer for indemnity," established indemnification of the insured's directors and officers. The court reasoned that the quoted language rendered the bylaws conditional and that a conditional requirement for indemnification failed to satisfy the policyholder's obligation to allege that indemnification has occurred.

The court also addressed the sufficiency of the insured's "breach of the duty of good faith and fair dealing" claim. Noting that the "Texas Supreme Court has rejected application of the duty of good faith to third-party insurance cases," the court explained that the "relevant question is thus the characterization of the claim at issue as either a third-party or a first-party claim." The court noted that "[t]he insured's indemnification of its directors and officers is a loss to the insured. It does not flow directly to a third-party, but rather covers the insured for monies expended." The court thus concluded that the disputed coverage was a first-party claim "because the insurer's duty to pay runs directly to the insured as the insured. It protects the insured against loss actually paid (the insured's own loss) rather than loss arising from liabilities (injuries to a third party)."

Finally, the court dismissed the insured's "unfair settlement practices," "deceptive trade practices" and "failure to promptly pay claims" causes of action for failure to plead compliance with statutory notice requirements. Rejecting the insureds' argument that pleading notice was merely a condition precedent to which general pleading is sufficient, the court concluded that, absent the requisite notice, the insureds had failed to state a cause of action under Texas law but explained that the proper cure for defective statutory notice is abatement. Accordingly, the court granted the insurers' motion to dismiss but likewise granted the insured leave to amend its complaint and abated its statutory causes of action.

For more information, please contact us at 202.719.7130