

First Circuit Affirms Ruling for D&O Carrier Based on Prior and Pending Litigation Exclusion

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The United States Court of Appeals for the First Circuit has affirmed a grant of judgment on the pleadings in favor of a D&O carrier on the grounds that the prior and pending litigation exclusion in the policy at issue precluded coverage. *Federal Ins. Co. v. Raytheon Co.*, 2005 L 2708226 (1st Cir. Oct. 21, 2005). The court held that the exclusion precluded coverage for an ERISA action where there was "substantial overlap" with the facts alleged in a securities class action filed prior to the policy period.

The insurer issued a D&O policy that contained a prior and pending litigation exclusion:

The Company shall not be liable for Loss on account of any Claim made against any Insured . . . based upon, arising from, or in consequence of any demand, suit or other proceeding pending, or order, decree or judgment entered against any Insured, on or prior to [September 15, 2000], or the same or any substantially similar fact, circumstance or situation underlying or alleged therein.

In October 1999, prior to the inception date of the policy, a securities class action was filed against the insured company and certain of its directors and officers, alleging that the defendants issued materially false and misleading statements regarding the company's financial performance. Nearly four years later, in May 2003, a second class action was filed against the company and certain of its directors and officers, alleging that they were ERISA fiduciaries of the company's employee retirement plan and that they violated their fiduciary duties. The appellate court noted that "[a]part from differences in parties and legal theories, the factual allegations of the ERISA complaint were in many respects nearly identical to the Securities complaint." The court further noted that the major differences between the ERISA and securities complaint were that: (1) the later-filed ERISA complaint contained allegations of wrongful acts that occurred after the close of the class period that were necessarily not included in the securities complaint and (2) the ERISA plaintiffs were required to plead certain facts to maintain their ERISA cause of action that were not required to maintain an action for violation of the securities laws.

The company tendered defense of the ERISA action to the insurer, which denied it had any duty to defend or indemnify. The insurer subsequently filed an action seeking a declaration that the prior and pending litigation exclusion precluded coverage. The district court granted the insurer's motion for judgment on the pleadings.

On appeal, the court first rejected the company's contention that the applicability of the prior and pending litigation exclusion was not ripe for adjudication until both underlying actions were concluded. The court reasoned that Massachusetts law obligates courts to evaluate initially an insurer's duty to defend solely based on a comparison of the applicable policy and the subject complaint(s).

Turning to the applicability of the prior and pending litigation exclusion, the court first indicated that the mere presence of the company as a defendant in two actions was not sufficient to trigger the exclusion absent some factual linkage but that "complete identity between the lawsuits is plainly not required." Construing the term "based upon" as used in the exclusion, the court concluded that "the policy thus requires the allegations in the second complaint find substantial support in the first complaint, *i.e.* that the allegations of the second complaint substantially overlap those of the first" in order to trigger the exclusion.

The court also explained that "[r]equiring a substantial but not complete overlap with the prior complaint also serves the policy behind such prior and pending litigation exclusion clauses." The court reasoned that the "most direct[]" effect of such exclusions is the promotion of prompt notice from policyholders and the avoidance by insurers of attempts to stack limits of successive policies to cover a single claim or closely related claims. Characterizing the second facet of this explanation as the "problem of adverse selection," the court stated that "the insurance company's legitimate interest in combating the adverse selection problem is properly implicated when there is a real and substantial overlap with the complaint in the prior lawsuit, as opposed to an incidental or fortuitous relationship to the prior complaint."

Applying the "substantial overlap" standard to the facts of the instant case, the court held that the prior and pending litigation exclusion precluded coverage because "a substantial part of the operative facts alleged in the ERISA complaint appears in the Securities complaint." The court based this conclusion on the fact that the ERISA complaint contained allegations of wrongdoing almost identical to the allegations of wrongdoing in the securities complaint prior to the cut-off date for the class period. The court also held that the fact that the ERISA complaint contained post-class-period allegations of wrongdoing not found in the securities complaint did not prevent application of the exclusion. The court reasoned that "acknowledging that there are substantial areas of non-overlap does not defeat the fact that there is a substantial overlap between the two complaints."

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