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ALERT

"Insured v. Insured" Exclusion Does Not Turn on Insured's Status at the Time of Claim

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The United States Court of Appeals for the Third Circuit, applying New Jersey law, has held that an "insured v. insured" exclusion barred coverage for a derivative count of an action brought with the active participation of a former officer of the insured entity. *Foodtown Inc. v. National Union Fire Ins. Co. of Pittsburgh, PA*, 2011 WL 37816 (3d Cir. Jan. 6, 2011). The court rejected the insurer's contention that other counts of the underlying action, though brought as direct claims, were actually "disguised derivative claims" that would fall within the exclusion. The court also rejected the insurer's argument that the policy's exclusion for claims rising out of contractual liability applied to the underlying action. However, the court affirmed the district court's application of a "specific entity exclusion" to allegations of the underlying action connected with other claims against the designated entity.

The insurer issued a directors and officers liability policy to the insured, a closely held grocery store cooperative. In the underlying action, a shareholder of the insured entity made various allegations against the insured and its board of directors. Count One included derivative allegations that the board of directors misused the company's trade names and service marks. The insurer contended that, because the action was brought with the participation of the insured entity's former president, the claim was barred under the "insured v. insured" exclusion of the policy. That exclusion barred coverage for claims brought on behalf of the insured organization against an individual insured, unless brought independently and without the participation of any individual insured.

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Citing the court's earlier opinion in *Township of Center v. First Mercury Syndicate,* 117 F.3d 115, 118 (3d Cir.1997), the insured contended that the former officer's prior status as president was irrelevant and that the insured v. insured exclusion did not apply because he was not a director or officer of the insured entity at the time the underlying action was brought. The court rejected this argument, noting that *Township of Center* was decided under the law of Pennsylvania–not New Jersey–and that the insured cited no New Jersey precedent relying on it. More importantly, the court reasoned, the relevant policy language here differed from that in *Township of Center*. The policy at issue defined "individual insured" to include a "past, present or future . . . director [or] officer." In light of this plain language, the court concluded that there was no need to consider the rationale for the exclusion, as suggested by the insured. The former officer was an insured individual, and his active participation in the underlying action precluded coverage for the derivative allegations.

The insurer contended that the same exclusion applied to two other counts of the underlying action that, although brought as direct counts, were assertedly "disguised derivative" allegations. Count Two of the underlying action alleged that the insured's board had interfered with the claimant's attempt to be assigned the insured entity's right of first refusal in the event of a sale of a member grocery store. Count Four asserted breach of fiduciary duties by the insured's board in connection with its purported discrimination and favoritism among shareholders. The court determined that these counts asserted discrete and particularized injury to the claimant or its shares, rather than harm sustained by the insured entity generally. Accordingly, the counts were not derivative, and the policy's exclusion for claims brought against an individual insured on behalf of the insured organization did not apply.

The insurer also contended that Count Two of the underlying action implicated the policy's exclusion for claims "alleging, arising out of, based upon, or attributable to any actual or alleged contractual liability of an Insured." The insurer contended that Count Two arose out of a contractual agreement of a past director of the entity to sell its store to the claimant, an agreement that the claimant had asserted the insured entity wrongfully permitted the seller to revoke. Without this contract, the insurer argued, there would be no Count Two. The court rejected this argument, holding that Count Two did not arise out of the contractual *liability* of an insured. According to the court, the fact that the alleged breach of fiduciary duties occurred in the context of an alleged contract entered into by an insured, in his capacity as owner of his own member grocery store, did not implicate the contractual liability exclusion.

Finally, the claimant appealed the district court's determination that Count Three of the underlying action was excluded by the policy's "specific entity exclusion." This exclusion barred coverage for loss in connection with claims brought against a specifically designated entity or any of its directors or officers. Count Three of the underlying action alleged that the insured entity failed properly to allocate payments connected with a settlement of issues presented during the bankruptcy proceedings of the designated entity. The insured contended that Count Three was not "brought against" the designated entity, but rather sought a fair allocation of debt incurred to settle a claim that the designated entity had brought against the insured and members of its board. The court concluded that the exclusion applied because the bankruptcy proceedings from which the underlying dispute arose were claims brought against the directors and officers of the designated entity. Accordingly, Count Three was barred by the plain language of the exclusion, which barred

coverage for loss "in connection with" any claims against the directors and officers of the designated entity.

Because the insured had obtained favorable coverage rulings, the court affirmed the district court's award of attorneys' fees pursuant to New Jersey law and found no abuse of discretion in its decision to award all fees incurred by the insured in pursuing its coverage claims.