

ALERT

Magistrate Judge Recommends Stay of Coverage Action Where Coverage Issues Overlap with Underlying Lawsuit and Insureds Would Suffer Prejudice If Action Allowed to Proceed

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A magistrate judge in the United States District Court for the Eastern District of California has recommended staying a coverage action based on the conclusion that the coverage issues overlap with issues in the underlying litigation against the insureds and that the insureds would be unfairly prejudiced if the coverage action were allowed to proceed. *Carolina Cas. Ins. Co. v. Helsley, PC*, 2011 WL 121576 (E.D. Cal. Jan. 13, 2011).

The lawyers professional liability policy at issue precluded coverage for claims arising out of the insured's acts as an officer, director, partner, trustee, or employee of any business other than the insured law business and for claims made "in connection with . . . [a business] . . . in which the Insured owns more than a 10 percent interest, or in which any Insured is an owner, partner, or employee, or which is directly or indirectly controlled, operated or managed by any Insured" (the "Business Enterprise Exclusions").

The insureds provided legal services to a client in connection with the formation of various limited liability companies organized to pursue real estate ventures. Upon formation, one of the insureds received a membership interest in two of the LLCs. The client later filed suit against the insureds claiming losses in connection with the LLCs' formation and real estate ventures. The clients alleged that the insureds breached their professional duties and breached fiduciary

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duties in connection with the operation and ownership of the LLCs they helped form. The complaint against the insureds attributed significant ownership and/or control of the LLCs to the insured who held an ownership interest in two of the LLCs.

The insurer agreed to defend the action against the insureds under a reservation of rights and filed coverage litigation seeking a declaration that the Business Enterprise Exclusions barred coverage. The insureds filed a motion to stay the coverage action until the underlying litigation was resolved, claiming that the issues in the coverage action could not be adjudicated without adjudicating facts at issue in the underlying action thereby exposing them to inconsistent and potentially prejudicial determinations in the two lawsuits. The insureds also asserted that they would be prejudiced by having to proceed with the coverage action while simultaneously defending the underlying lawsuit and being represented in the underlying lawsuit by counsel employed by the insurer. The insurer disagreed, contending that the facts necessary to determine whether the Business Enterprise Exclusions were implicated were a matter of record and not subject to legitimate factual dispute. The insurer also asserted that it would suffer more prejudice by having to defend the insureds in the underlying action than the insureds would by having to proceed with the coverage action.

The court agreed with the insureds and recommended staying the case. In reaching this conclusion, the court noted that, in the underlying litigation, the client alleged that the insureds (or some of them) were officers and/or directors and/or trustees of the LLCs and that they breached their duties in connection with these roles. The court stated that whether the insureds held these roles at the LLCs also was at issue in the coverage action, and was a point that the insureds disputed. The court explained that the insureds were in a “lose-lose situation” because a finding on this issue adverse to the insureds in the coverage action would bind them in the underlying litigation, while a favorable determination would not bind the claimant in the underlying lawsuit.

The court agreed with the insurer that the fact and percentage of the insureds’ ownership in the LLCs should be simple matters of record and not subject to dispute and that the client’s lawsuit did not turn on proving ownership. However, the court concluded that discovery into the ownership issue could not reasonably be conducted without forcing the insureds to take positions adverse to their interests in the underlying litigation and would create unduly expensive and time-consuming discovery disputes in the coverage action. The court also expressed concern that the “potential appeal” of the client’s case in the underlying lawsuit could be strengthened by a finding in the coverage case that the insureds held significant ownership interests in the LLCs.

The court additionally concluded that, if the stay were not granted, the prejudice to the insureds would far outweigh the prejudice to the insurer. In reaching this conclusion, the court considered the fact that the insureds hired counsel at their own expense in the underlying litigation based on the carrier’s refusal to provide independent counsel and that the insureds had no other insurance coverage for the underlying litigation.