HUNTON& WILLIAMS

INSURANCE LITIGATION ALERT

September 2010, Vol. 7

Second Circuit Finds "Insured vs. Insured" Exclusion Ambiguous In a Contract for D&O Liability Insurance

Contacts

Walter J. Andrews
(703) 714-7642
wandrews@hunton.com

Lon A. Berk
(703) 714-7555
lberk@hunton.com

Lawrence J. Bracken II
(404) 888-4035
lbracken@hunton.com

Neil K. Gilman
(202) 955-1674
ngilman@hunton.com

John W. Woods
(202) 955-1513
jwoods@hunton.com

Robert J. Morrow
(212) 309-1275
rmorrow@hunton.com

Michael S. Levine
(703) 714-7602
mlevine@hunton.com

Sergio F. Oehninger
(703) 714-7552
soehninger@hunton.com

Syed Ahmad, of the firm's McLean office, authored this Alert.

The United States Court of Appeals for the Second Circuit has ruled that the "insured vs. insured" exclusion in a Directors and Officers ("D&O") liability policy is ambiguous in a case brought by the legacy entity's directors and officers against representatives of a newly formed corporate entity. *Macey v. Carolina Cas. Ins. Co.*, ___ F.3d ___, 2010 WL 2595299 (2d Cir. June 30, 2010).

Background

Community Research Associates ("CRA-Illinois") was an Illinois corporation controlled by directors and officers Doyle Wood, James Brown and Allen Cole. In May 2004, CRA-Illinois reorganized and emerged as a new entity incorporated under Delaware law ("CRA-Delaware"). Following the reorganization and pursuant to a stock purchase agreement ("SPA"), Sterling Investment Partners ("Sterling") became the majority shareholder of CRA-Delaware. The SPA allowed Sterling to nominate individuals for the board of directors and, under certain circumstances, the chairman of the board. As a part of the reorganization, Messrs. Wood, Brown and Cole agreed to become minority shareholders after the merger was complete and new board members were appointed.

CRA-Delaware purchased a management liability insurance policy from Carolina Casualty Insurance Company ("Carolina Casualty"). Subject to its terms, the policy provided coverage for "any Wrongful Act," including a breach of fiduciary duty. The policy had an effective date of October 10, 2004. The policy also contained an "insured vs. insured" exclusion, which barred coverage for claims "by, on behalf of, or in the right of the Insured Entity, or by any Directors or Officers." The policy defined "Director(s) or Officer(s)" as "any past, present or future duly elected or appointed directors or officers of the Insured Entity."

Following another reorganization, in August 2005, a merger occurred whereby CRA-Delaware stock was transferred to CRA Acquisitions Corp. After the merger, and after Messrs. Wood, Brown and Cole had relinquished all ownership interest in and control over CRA-Delaware, the three former directors brought a lawsuit concerning the merger against various individuals, alleging a breach of fiduciary duty. That suit was settled for $3 million.

Carolina Casualty denied coverage for the lawsuit, relying on the policy's "insured vs. insured" exclusion. Carolina Casualty argued that as former officers

and directors, plaintiffs Wood, Brown and Cole came squarely within the scope of the exclusion, which barred coverage for, among other things, lawsuits brought by present or former officers or directors. The district court, applying Virginia law, held that the "insured vs. insured" exclusion was unambiguous and barred coverage for the suit. Summary judgment was entered in favor of Carolina Casualty.

Second Circuit's Decision

The defendants in the underlying litigation who had sought coverage appealed the award of summary judgment and the Second Circuit reversed. Two competing arguments were presented on appeal. The appellants argued that the "insured vs. insured" exclusion could not apply because CRA-Delaware, the insured entity, did not come into existence until 10:00 a.m. on May 3, 2004, after the closing of the transaction with Sterling. The appellants contended, therefore, that they could not possibly have been directors or officers of CRA-Delaware at the relevant time because CRA-Delaware did not even exist. This, the appellants claimed, occurred at the same time that Messrs. Wood and Brown resigned. Carolina Casualty argued, on the other hand, that CRA-Delaware had come into being prior to the resignation by Messrs. Wood and Brown, thus enabling Messrs. Wood and Brown to be officers and directors of CRA-Delaware such that their suit against the corporate entity would come within the scope of the "insured vs. insured" exclusion.

The Second Circuit found that the policy language could support either interpretation and was thus ambiguous. Under Virginia law, where a contract has been found to be ambiguous, the court is free to consider evidence extrinsic to that contract in order to ascertain the contract's true meaning. The Second Circuit did not, however, examine any parol evidence that had been cited by the parties. Rather, the Second Circuit explained that it would be more appropriate for the finder of fact — in this case, the trial court — to consider that evidence. Accordingly, the court remanded the case for further proceedings.

Implications

The *Macey* decision is noteworthy because it illustrates the significant impact that the details of corporate transactions can have on the application of coverage and exclusionary provisions in contracts for corporate director and officer insurance. As illustrated by the decision in Macey, the precise timing and structure of such transactions must be understood along with the decisions that led to the transaction. The decision also underscores the importance of understanding the scope of responsibility held by corporate officers and directors when analyzing coverage. Additionally, the decision emphasizes that resolving the intended meaning of an ambiguous provision is an issue of fact that should be decided by the fact finder based on the evidence.

© 2010 Hunton & Williams LLP. Attorney advertising materials. These materials have been prepared for informational purposes only and are not legal advice. This information is not intended to create an attorney-client or similar relationship. Please do not send us confidential information. Past successes cannot be an assurance of future success. Whether you need legal services and which lawyer you select are important decisions that should not be based solely upon these materials.