White and Williams LLP

Courts Agree That "Insured v. Insured" Exclusion Bars Coverage in "Mixed Actions"

Insurance Coverage and Bad Faith Alert **| April 21, 2017**
By: Greg Steinberg

Third-party liability insurers are not in the business of resolving first-party claims or getting tangled up in corporate infighting. That is one reason why the Insured v. Insured exclusion is a standard exclusion in most management liability insurance policies. The Insured v. Insured exclusion will typically bar coverage for Claims brought "by or on behalf of" an Insured. The exclusion is fairly straightforward when one Insured sues another Insured – the exclusion will bar coverage for the Claim. However, the issue becomes more difficult when a lawsuit is brought by both Insureds and non-insureds. In these "mixed actions," the court must determine whether the exclusion applies to bar coverage for the entire lawsuit despite the existence of a non-insured plaintiff. In January 2017, two courts addressed this issue and held that the Insured v. Insured exclusion operated to bar coverage for the entire action.

In *Jerry's Enterprises, Inc. v. U.S. Specialty Insurance Company*, the United States Court of Appeals for the Eighth Circuit addressed the Insured v. Insured exclusion in a "mixed action." Cheryl Sullivan, an Insured Person and former member of the board of directors of Jerry's Enterprises, Inc. (JEI), along with her two daughters (non-insureds), sued JEI and two JEI board members alleging that the JEI board members forced Ms. Sullivan and her daughters to redeem their JEI shares below fair value. U.S. Specialty denied coverage based on the Insured v. Insured exclusion, which provided that "the Insurer will not be liable to make any payment of Loss in connection with a Claim brought by . . . any Insured Person."

JEI argued that the Insured v. Insured exclusion did not apply because two of the plaintiffs were not Insureds. The court rejected this argument because "the policy defines Claim as a civil proceeding commenced by service of a complaint, i. e., the entirety of the Sullivan lawsuit." The court therefore refused to "apply the [exclusion] to some parts of the lawsuit but not others."

As a fallback argument, JEI argued that because the U.S. Specialty policy contained an allocation provision, U.S. Specialty should provide coverage for the settlement of claims solely attributable to non-insureds. JEI relied on *Level 3 Communications, Inc. v. Federal Insurance Company*, in which the court declined to apply an Insured v. Insured exclusion to bar coverage for an entire action, and instead allocated loss between "covered and uncovered matters" where one of eight plaintiffs was a former company director who joined the lawsuit six months after it was filed.

The court rejected JEI's allocation argument, noting that Ms. Sullivan "was the driving force of the litigation" because "she owned the vast majority of shares at issue in the underlying lawsuit, and she was the former director who repeatedly raised concerns about the valuation of shares to JEI's board of directors." The court noted that unlike in *Level 3*, Ms. Sullivan brought suit as one of the original plaintiffs and was not a "passive shareholder who joined the lawsuit six months after it had been filed."

Just three weeks later, in *The Marbella Condominium Association, et al. v. RSUI Indemnity Company*, the United States District Court for the Southern District of Florida addressed the same issue. The plaintiffs in the underlying action, Jack Leone (Insured) and Franklyn Field (non-insured), filed suit against Marbella and other parties alleging that the plaintiffs installed faulty hurricane impact doors at a condominium. The Insured v. Insured exclusion provided that "the Insurer shall not be liable to make any payment for Loss in connection with any Claim made against any Insured brought by or on behalf of any Insured..."

RSUI argued that the Insured v. Insured exclusion applied to bar coverage for the entire underlying action. In response, the policyholder argued that the Insured v. Insured exclusion was not triggered because one of the plaintiffs was not an Insured. Relying on *Level 3*, the policyholder further argued that because the plaintiffs sought distinct damages, the court should treat the underlying action as two separate "Claims" and allocate "Loss" based on the allocation provision in the RSUI policy.

The court rejected the policyholder's argument and held that the Insured v. Insured exclusion barred coverage for the entire action. The court distinguished *Level 3* because that case "was initiated by persons whose claims were covered, and only later was another plaintiff, who was an insured, permitted to join." Instead, the court followed the reasoning in *PowerSports, Inc. v. Royal & Sunalliance Insurance Company* and *Sphinx International Inc. v. National Union Fire Insurance Company of Pittsburgh, Pennsylvania*. In those cases, the courts held that where an underlying action involves claims by both insureds and non-insureds from its inception, the plain language of the Insured v. Insured exclusion bars coverage for the entire underlying action. Moreover, in those cases the courts rejected the argument that a portion of the underlying action could be preserved for coverage based on the allocation provision.

IMPLICATIONS

On one hand, these decisions are important because they uphold the plain language of the Insured v. Insured exclusion and limit the application of a policy's allocation provision to instances where coverage has already been established. But the decisions have potentially wider implications. In both cases the court rejected the policyholder's attempt to "split up" the lawsuit into multiple "Claims" in order to preserve coverage for that portion of the "Claim" brought by a non-insured plaintiff. In this way, the decisions reinforce the principle that exclusions should be enforced as written, and absent a severability provision, an exclusion that applies to a "Claim" should exclude coverage for the entire "Claim."

If you have questions or would like additional information, please contact Greg Steinberg (steinbergg@whiteandwilliams.com; 212.714.3066) or another member of our Insurance Coverage and Bad Faith Group.