MODERN INTERPRETATION AND APPLICATION OF THE INSURED V. INSURED EXCLUSION

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The so-called “Insured versus Insured” – or “I v. I” – exclusion has been included on most management liability forms for over 30 years. Despite over three decades of interpretive case law, the application of the I v. I exclusion remains highly fact specific, and thus it remains difficult to predict how a court might interpret an I v. I dispute, particularly where there is no controlling precedent within that jurisdiction. Even where there are existing case decisions, the insurance practitioner must carefully analyze the facts of each case and the specific policy language at issue when counseling clients regarding I v. I coverage issues.

I. Introduction

Any discussion of the I v. I exclusion starts with the fundamental recognition that the D&O contract is one which protects against third-party liabilities incurred as a result of the acts and omissions of D&O policy’s insureds. Academic literature and D&O insurance practitioners are in general agreement that the I v. I exclusion was first developed in the early 1980s as a response to claims asserted by struggling banks against their own directors and officers, and the courts rejected the insurers’ pleas that such conduct was excluded from coverage.

At the time, the very concept of a company suing its own directors and officers to access the insurance policy proceeds was considered aberrational. Insurers therefore regarded such suits as collusive attempts by companies to access the proceeds of their D&O policies. Two such examples are Bank of Am. N.T. & S.A. v. Powers, No. 536-776, (Cal. Super. Ct. Mar. 1, 1985) and Nat’l Union Fire Ins. Co. v. Seafirst Corp., 662 F. Supp. 36 (W.D. Wash. 1986). In each, the banks sought to recover under their D&O policies for alleged wrongful acts committed by their own directors and officers, and the courts rejected the insurers’ pleas that such conduct was excluded from coverage.

The most basic form of I v. I exclusion precludes coverage for claims brought by the insured entity, or insured persons, against other insureds. However, as the exclusion evolved, certain exceptions to the exclusion— or “carve backs”—began to emerge. If the reason for the I v. I exclusion is to avoid collusive actions, then non-collusive actions should not implicate the exclusion. For this reason, a shareholder derivative action brought by someone other than a director or officer – or without the company’s involvement – would not be excluded. (Many such shareholder suit carve backs are therefore subject to a prerequisite that covered claims must be brought “totally independent” of insured persons, ensuring that

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1 See, John H. Mathias, Jr., et. al., Directors and Officers Liability: Prevention, Insurance and Indemnification § 8.02 (Rel. 27, 2014); see also, John F. Olson and Josiah O. Hatch, III, Director and Officer Liability: Indemnification & Insurance Vol. 1 §12:20 (2013-2014 Ed.).

2 Id. p. 966.
coverage is afforded only to pure third-party claims.) Similarly, the I v. I exclusion in many instances should not apply to whistleblower claims, claims brought by trustees and receivers, and claims brought by former directors who have been disassociated from the insured entity for some prescribed period of time, as in some contexts, the risk of collusive suits diminishes in direct proportion to the amount of time the executive has been disassociated from the insured entity.

Many of these exceptions are irrational, however, if the reason for the I v. I exclusion is to avoid intercorporate disputes or disincentivize the use of lawsuits as a mechanism to chase insurance proceeds only. For example, while the “collusiveness” of an ex-director’s lawsuit against her past company may not exist given the extreme adversity between the two parties, a “carve back” which allows such a lawsuit clearly brings the insurer back into the corporate fray. In other contexts, many insurers believe that the successors in interest to insurers back into the corporate fray. In other contexts, the risk of collusive suits diminishes in direct proportion to the amount of time the executive has been disassociated from the insured entity.

Exceptions to the I v. I exclusion have been heavily litigated, as practitioners and courts seek to apply the actual wording of the policy and, if unclear, then try to divine the true intent of the policy language. Below, we examine recent developments in several of the more frequently disputed I v. I issues.

II. Bank Crises – Old & New – and the Role of the Regulator

Litigation over I v. I exclusions began in earnest following the first wave of bank failures during the savings & loan (“S&L”) crisis of the 1980s. Between 1980 and 1989, more than 560 S&Ls with combined assets of more than $200 billion failed, due in large part to historically high interest rates and comparatively weak oversight, coupled with a deregulation of the supervisory agencies. In response to the S&L crisis, the Federal Savings and Loan Insurance Company (“FSLIC”), which was ultimately subsumed within the Federal Deposit Insurance Corporation (“FDIC”), was appointed as receiver to many of the failed banks. The FSLIC was tasked to assess whether an action should be brought against the institution’s own directors and officers for the bank’s failure. One of the principal factors in that assessment was the ability to satisfy any financial judgment or award and, when in many of the cases the individual officials had no tangible assets, the government targeted the D&O insurance policy limits. When D&Os sought coverage for the claims later asserted against them, many insurers cited the newly minted I v. I exclusions, taking the position that – as the FSLIC was “standing in the shoes” of the bank – the exclusion precluded coverage for claims it asserted against other policy insureds.


When interpreting the potential application of an I v. I exclusion in this context, courts focused on the unique scope of the exclusion in question and the extent to which the FDIC had “stepped into in the shoes” of the failed bank on a case-by-case basis. The FDIC is, of course, the successor to a failed bank institution when wearing the “hat” of receiver. But, according to applicable banking regulations, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (“FIRREA”) among them, the FDIC may also act – much in the same way a bankruptcy trustee might – so as to protect the rights of shareholders, creditors and depositors as well. Finally, of course, the FDIC can also act in its capacity as a regulator, as it remains the agency of the US government charged with the oversight [investigation and liquidation] of banks for the protection of the general citizenry. Thus, in many instances, where the
FDIC claimed it was acting in more than one capacity, and the policy exclusion in question was not sufficiently broad enough to encompass all, the courts declined to apply the exclusion.

Courts, however, did not hesitate to invoke the exclusion where the FDIC’s role clearly fell within the exclusion. In *Gary v. American Cas. Co.* of Reading, Pa., 753 F. Supp. 1547 (W.D. Okla. 1990), the district court concluded that where the FDIC affirmatively claimed in an amended complaint that the claims it was pursuing against the officers and directors were assets of the bank, it functionally confessed that it was suing only in its capacity as successor to the bank’s rights. The I v. I exclusion applied. Other cases have also concluded that when the FDIC is proceeding as a receiver, it is proceeding on behalf of the bank and the I v. I exclusion applies. See *Powell v. American Cas. Co.*, 772 F. Supp. 1188 (W.D. Okla. 1991) (“Because the insured versus insured specifically excludes any claims made by the “institution” ***, it follows that the FDIC’s action is excluded under the circumstances.”). While the decisions were all highly dependent on the facts of each case, the role of the agency in each, and the attendant policy language, the courts tended to recognize when the FDIC is acting as an Insured, the I v. I exclusion is applicable. But, when the FDIC legitimately claims to be acting in other capacities that do not fall within the exclusion, the exclusion would not apply. Of course, the FDIC can claim to be acting in different capacities and, once this dichotomy is revealed, in many cases the FDIC actually shifted its status so as to perfect the insurance entitlement.

As the S&L crisis wore on, insurers read these tea leaves and negotiated different policy language so as to clarify the intended application of the exclusion. For example, in several cases where the policy was enhanced to exclude claims asserted “in the right of” the bank, courts found that I v. I exclusions applied to claims asserted by the FDIC in its capacity as a receiver. See e.g. *Evanston Ins. Co. v. FDIC*, CV-88-0407 (C.D. Cal. May 17, 1988). In considering this language, the *Evanston* court held that common sense dictated that the phrase “in the right of” the bank included entities who assert the bank’s claims as a successor or representative. Because the FDIC was a successor and representative of the bank, the I v. I exclusion barred coverage for the FDIC claims. *Id.* at *1-2. See also *Powell v. American Cas. Co.*, 772 F. Supp. 1188 (W.D. Okla. 1991) (“because the insured versus insured [exclusion] specifically excludes any claims made by the ‘institution’ (i.e. [the Bank], it follows that the FDIC’s action is excluded[,]”); *Gary v. American Cas. Co.*, 753 F. Supp. 1547 (W.D. Okla. 1990) (the I v. I exclusion applies “regardless of whom the FDIC may represent and to whom the benefits of any claims asserted by it may inure” because the FDIC is asserting claims previously owned by the Bank, while the FDIC in its corporate capacity may assert claims only because it purchased those rights from the FDIC as liquidating agent).

With the second wave of bank failures that occurred as the result of the 2008 financial crisis, the FDIC once again took on the role of receiver and litigation over the application of the I v. I exclusion to the FDIC’s claims ensued. In the two decades that had passed, some insurers had scaled back the I v. I exclusions while others had simply dropped the enhancements made in the wake of the 1980-1990 coverage debates. As a result, once again the breadth of the exclusion and the “capacity” of the FDIC took to the fore, on a case-by-case basis. In the first two cases that considered an I v. I exclusion in the second bank failure wave, both the District of Puerto Rico and the Northern District of Georgia found that the policy language under their review did not preclude coverage for the FDIC’s claims. Compare *W Holding Co., Inc., et al v. Chartis Ins. Co.-Puerto Rico, et al.*, No. 11-2271, 2012 WL 5379039 (D.P.R. October 31, 2012) (although the exclusion ostensibly prevented the FDIC from bringing suit on behalf of the bank’s shareholders, the court found the FDIC’s action was not collateral and the FDIC sued in other capacities, such as on behalf of “depositors, account holders, and a depleted insurance fund” and in its role as a regulator) with *Progressive Ins. Co. v. FDIC*, 926 F.Supp. 2d 1337 (N.D. Ga. 2003) (although the exclusion applied to claims brought “by, on behalf of, or at the behest of the Company,” the FDIC could have been bringing claims not only “by” or “on behalf of” the bank, but also on behalf of the bank’s depositors, creditors, and shareholders).

In the handful of other cases considering an I v. I exclusion in the failed bank context since 2008, the Insureds or the FDIC asserted that the particular I v. I exclusion at issue was ambiguous and, at least at the early dismissal stage, not ripe for decision absent further discovery. In one notable case, the Northern

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3 The “regulatory exclusion,” an adjunct to the I v. I exclusion, also emerged during this time period.
4 While *Evanston* addressed the role of the FDIC in its corporate capacity, its reasoning applies equally to cases in which the FDIC is acting as receiver, because it held that “in the right of” includes “assignees, who purchase and then assert the claims of the bank, as well as entities who assert the claims of the bank in a representative capacity.” *Id.* at *1-2.
District of Georgia firmly disagreed that the I v. I in question was ambiguous. However, that decision was later reversed by the 11th Circuit and remanded for further proceedings. *St. Paul Mercury Ins. Co. v. Miller*, 968 F. Supp. 2d 1236 (N.D. Ga. 2013) (“The result of the cases determining whether to apply an insured v. insured exclusion to the FDIC usually turns more on the language of the exclusion rather than the adoption by courts of a supposed majority or minority rule.”), rev’d, *St. Paul Mercury Ins. Co. v. FDIC*, 774 F.3d 702 (11th Cir. 2014) (“An important indication of ambiguity in a policy is whether nearly identical or similar language has been construed differently by other courts.”). In other words, simply because other courts had come to different conclusions when applying different policy language and fact patterns, the exclusion was considered ambiguous per se under Georgia law. See also, *St. Paul Mercury Ins. Co. v. Hahn*, No. 13-0424, 2014 WL 5369400 (C.D. Cal. October 08, 2014) (finding the policy’s I v. I provision to be ambiguous as applied against the FDIC); *Progressive Cas. Ins. Co. v. FDIC*, No. 11-14816, 2012 WL 8437693 (E.D. Mich. September 24, 2012) (same). But see *Progressive Cas. Ins. Co. v. F.D.I.C.*, --- F.Supp.3d ----, 2015 WL 310225 (N.D. Iowa 2015) (distinguishing its findings from those made under Georgia law in *St. Paul Mercury*, the court held that “[i]n contrast, under Iowa law, ‘ambiguity’ is a matter of ‘interpretation,’ not ‘construction,’ [citation omitted], and I found the meaning of the ‘insured vs. insured exclusion’ unambiguous using Iowa rules of interpretation,” yet also finding that it did not apply in that instance.)

In contrast, where the policy language in question tends towards the more specific, courts have been more inclined to invoke the provision. See e.g. *Hawker v. BancInsure, Inc.*, No. 12-1261, 2014 WL 1366201 (E.D. Cal. April 07, 2014) (summary judgment granted where the exclusion specifically referenced a “receiver”).

Clearly, however, very few decisions have been rendered in this second wave of bank failures. Those that have issued are sprinkled across varying jurisdictions, and are highly dependent on the precise insurance language at issue, reinforcing a theme of this article: that the insurance practitioner should be reluctant to place undue weight on precedential authority when advising clients as to the applicability of the I v. I exclusion. Given that the spike in the rate of bank failures since 2008 seems to have leveled off and is now returning to more normal levels, it may be that the FDIC, the Insureds and the insurers have rapidly diminishing opportunity to fully vet their arguments about the purpose and driving principles behind the application of modern I v. I exclusions to failed financial institution

### III. Other Types of I v. I Activity Implicated

Principles akin to those outlined in the FDIC cases above have been applied to other kinds of corporate representations, such as bankruptcy trustees, creditors committees and debtors-in-possession when pursuing claims against a debtor’s D&Os. See e.g., *Bilmore Assocs. v. Twin City Fire Ins. Co.*, 572 F.3d 663 (9th Cir. 2009); *Bilmore Associates, LLC, as Trustee Of The Visitalk Creditors Trust v. Twin City Fire Insurance Company, et al.*, 572 F.3d 663 (9th Cir. 2009). Some courts have applied I v. I exclusions in these contexts, finding regardless of who may ultimately receive such funds, the cause of action being asserted derives solely from the insured corporation itself. *Reliance Ins. Co. of Illinois v. Weis*, 148 B.R. 575 (E.D.Mo. 1992), aff’d, 5 F.3d 532 (8th Cir. 1993) (“It is clear that the pending state court action was filed on behalf of [the Insured] and its estate, although the benefits sought may eventually inure to the creditors.”), cert. denied, 510 U.S. 1117 (1994). Others have made distinctions between such entities and the pre-bankruptcy debtor. See e.g., *Federal Ins. Co. v. Continental Cas. Co.*, 2006 WL 3386625 (W.D.Pa. 2006) (relying on finding that the debtor’s estate representative is separate from the debtor itself).

Other questions arise when former directors and officers pursue the company after their departure. Most I v. I exclusions specifically contemplate the instance in which a former official brings an action against the company, seeking to tap into available D&O coverage. As a result, creative plaintiffs attempt to characterize themselves into a carve back to the exclusion, such as for derivative actions or wrongful employment actions. Courts have rejected such actions. *American Sec. Bank & Trust Co. v. Progressive Cas. Ins. Co.*, No. 11-00096, 2011 WL 2531311 (M.D.Tenn. June 24, 2011) (dismissal granted on a lawsuit by a company’s director, officer and shareholder, despite a carve back for derivative actions, because the exclusion required the Claim be brought independently of, and totally without the solicitation, assistance, participation, or intervention of any Insured); *Franklin Holding Corp. (Delaware) v. National Union Fire Ins. Co. of Pittsburgh, Pa.*, 261 A.D.2d 146, 689 N.Y.S.2d 492 (1st Dep’t 1999) (the I v. I exclusion “clearly and unambiguously excludes coverage of the derivative and class action claims that were brought against plaintiff by its former director.”); *Strange v.
I exclusion applied to class action in which plaintiff was assisted by a former director of the insured).

IV. The Allocation Debate

A. Miller and Sphinx

Another frequently disputed I v. I issue concerns circumstances where an insured joins other non-insureds to bring a claim against the insureds. This issue has been frequently litigated where: (1) there is no express shareholder carve back; (2) there is a shareholder carve back that carries with it a prerequisite that covered claims be brought “totally independent” or without the “active assistance of” an insured person, so as to afford coverage only to pure third-party shareholder disputes; and (3) the policy’s general terms and conditions include a provision controlling allocation where there are both covered and non-covered claims.

Several viewpoints have emerged. Some courts have held where a policy has a stand-alone allocation provision, the claim is covered, and the parties should allocate between what is covered and what is not. Other courts have held even where there is an allocation clause, the entire claim is precluded from coverage. Still others have found that the language in many I v. I shareholder carve backs requiring that to be covered, the shareholder action must be brought “totally independent” and “without the active assistance of” an insured person, completely bars a “mixed” claim from coverage. These perspectives are addressed in turn.

Arguably, the leading case decisions with respect to the “allocation school” are the Seventh Circuit’s decisions in Level 3 Comm., Inc. v. Federal Ins. Co., et al., 168 F.3d 956 (7th Cir. 1999) and Miller v. St. Paul Mercury Ins. Co., 683 F.3d 871 (7th Cir. 2012). In Level 3, the litigation was not initially brought by any insureds; rather insureds were later added to a shareholder class action. Coverage litigation followed involving a number of issues including the application of an I v. I exclusion. The I v. I exclusion did not have a shareholder carve out, but did contain an allocation provision. When considering this policy language, Judge Posner held that allocation was appropriate between the covered claims brought by non-insureds, and the uncovered claims brought by insureds. The court reasoned that to hold otherwise would lead to the very unusual situation of an initially covered claim being rendered uncovered simply because of the later addition of a prohibited plaintiff. For over a decade, carrier side practitioners argued that these specific facts limited Level 3’s application to instances where an insured plaintiff was later added to a claim that did not previously implicate the I v. I exclusion; however, Level 3’s rationale was rearticulated and arguably broadened in 2012 by Miller.

In Miller, three former directors, along with non-insureds, sued the insured entity and two of its directors and officers. Thus, at the outset, Miller was different than Level 3 because the claim was “mixed” at the time it was initially filed. As with Level 3, the Miller I v. I exclusion was silent as to whether shareholder suits were covered. Nevertheless, the trial court held the I v. I exclusion barred coverage for the entire action. On appeal, the Seventh Circuit reversed the trial court in an opinion that included an expansive analysis of Level 3 and other I v. I case law on the mixed claim issue. In holding that coverage (both defense and indemnity) was afforded for the claims by the non-insured plaintiffs (subject to the policy’s allocation provision), and expanding the reach of Level 3, the court remarked that:

[w]e decline St. Paul’s invitation to impose arbitrary limits on the reasoning of Level 3 Communications, whether based on the timing of the insured’s entry into the lawsuit, the proportion of damages sought by insureds, or the active versus passive involvement of the insureds. The allocation clause in the St. Paul policy leads to the proper result: claims brought by or on behalf of insureds are excluded, while those brought by non-insureds are not.

Id. at 879 (emphasis added). Thus, the Miller court found that, under the policy language in question, where there are claims brought by both insureds and non-insureds, coverage should be afforded to the non-insureds’ claims subject to the policy’s allocation provision. It should be noted, however, that the Miller court also expressly and unequivocally left the door open for a broader application of the I v. I exclusion, such as that as espoused by the Eleventh Circuit in an opinion predating Miller (Sphinx, discussed below). That is, the Miller court conceded it may have reached a different conclusion if the shareholder exception to the I v. I exclusion at issue in Miller had the “totally independent” prerequisite found in many I v. I shareholder exception provisions.

In Sphinx Int’l, Inc. v. National Union Fire Ins. Co. of Pitt., 412 F.3d 1224 (11th Cir. 2005), a corporate officer and shareholder brought a lawsuit against his
former company. Shortly after filing his complaint, the executive published a notice in a national newswire service soliciting other shareholders. As a result, eight additional shareholders were added to the complaint, relying on the I v. I exclusion. In distinguishing Level 3 and holding coverage was precluded, the Eleventh Circuit relied on the Sphinx D&O Policy’s I v. I exclusion’s language:

Here, in contrast, the D&O policy is much broader, barring coverage for claims “By or at the behest of . . . any DIRECTOR or OFFICER . . . unless such CLAIM is instigated and continued totally independent of, and totally without the solicitation of, or assistance of, or active participation of, or intervention of, any DIRECTOR or OFFICER or the COMPANY or any affiliate of the COMPANY.” While the language in Level 3 Communications gave the court some wiggle room, the language in our case is plain and clear, compelling our conclusion that Genesis need not cover Sphinx for Taylor’s lawsuit.

Id. at 1231. Importantly, in Miller, the Seventh Circuit did not disagree with the Eleventh Circuit’s quoted conclusion, holding that: “we have no disagreement with that [i.e., Sphinx] reasoning, but we find no similar language [i.e., a shareholder carve out] in the St. Paul policy that would defeat coverage for a claim by a non-insured plaintiff depending on whether she acted independently of insured plaintiffs.” Miller, 683 F.3d at 879. The Miller court further observed a “proper appreciation of the different policy language in the two cases is more than sufficient to support the Eleventh Circuit’s ruling without reading into the decision any arbitrary limit on Level 3 Communications.” Id.

Interestingly, the Miller court appeared to distinguish Sphinx exclusively on the grounds of the Sphinx policy’s I v. I language, which included the “totally independent” language in the carve out for claims brought by non-insureds; that is, in discussing Sphinx, there was no discussion of the allocation issue. Similarly, in Sphinx, the Eleventh Circuit focused on the “totally independent” language that was not present in Level 3. In contrast, the result in Miller was justified both on the grounds that the Miller I v. I exclusion lacked the “totally independent” language and the fact that the Miller policy had an allocation provision. The authors are not aware of any authority discussing the application of the I v. I exclusion to “mixed” claims where the policy at issue had both: (1) “totally independent” language in the I v. I carve out; and (2) an allocation provision.

B. Powersports, Inc. v. Royal & SunAlliance Ins. Co.

A further case that deserves mention on the I v. I/ allocation issue is Powersports, Inc. v. Royal & SunAlliance Ins. Co., 307 F. Supp. 2d 1355 (S.D. Fla. 2004). Powersports was a mixed claim, where the plaintiffs included two former directors of Powersports who, thus, qualified as insureds. The third plaintiff was a company owned and controlled by the two individual insureds. The carrier disclaimed coverage, relying on the narrowly tailored I v. I exclusion, which did not contain “totally independent” language. Nevertheless, the court held that the I v. I exclusion barred coverage for the entire claim, notwithstanding the fact that the policy at issue had an allocation provision. In so holding, the court observed the result made sense, and was distinguishable from Level 3, because the claim was not covered from the outset due to the presence of insured plaintiffs at the time of filing. Id. at *1361 (“[A]lthough allocation clauses recognize that covered and non-covered claims may coexist in the same action, the allocation clause is not what makes them so.”)


The application of the I v. I exclusion continues to be litigated. As of the date of this writing, the allocation issue is on appeal before the Ninth Circuit in AMERCO v. Nat’l Union Fire Ins. Co. of Pittsburgh, Pa., No. 13-2588, 2014 WL 2094198. Appellate briefing was completed in December 2014. In the underlying case, the District of Arizona considered the Miller-Sphinx split of authority. Id., at *1 (D. Ariz. May 20, 2014) (interpreting Arizona law). The trial court held the “totally independent” prerequisite (i.e., that a shareholder claim triggered coverage only if there were no insured co-plaintiffs) in the shareholder suit I v. I carve back barred coverage for a “mixed” I v. I claim. In so holding, the court focused first on the Policy’s “totally independent” language. Id. at *17.

The Amerco court further held, however, that because the policy at issue did not have an allocation provision, Sphinx, rather than Miller, controlled. Id. at *20.
On appeal, National Union has advanced the argument that allocation, whether express (i.e., granted by contractual provision) or implied, assumes both covered and non-covered claims in the same action. National Union has argued where there is an I v. I exclusion with a shareholder exception that requires the claim to be brought by a shareholder totally independently of an insured person, the exception does not apply to any mixed claim. Because a “mixed” I v. I claim is not covered from the outset when applying the “totally independent language”, allocation would never be appropriate regardless of whether the policy contains an allocation provision.

III. Conclusion

While litigation over any insurance policy exclusion is bound to be fact specific, I v. I exclusions present particular challenges. This is because the actual language of the policies differs, including as concerning the existence of carve back exceptions. Questions present as to the identity and “capacity” of the plaintiff, while many of the exceptions to the I v. I exclusion include a factual prerequisite that must be satisfied. Further complicating matters is the disparate views various courts have taken to the application of the exclusion, leaving the D&O insurance lawyer with no firm precedent in many jurisdictions. Thus, when counseling industry clients on the I v. I exclusion, it behooves the practitioner to weigh not only the facts unique to her case, but also factor in the controlling (and potentially conflicting) precedent, along with the judicial temperament of the jurisdiction with respect to interpretation of insurance contracts as a general matter.